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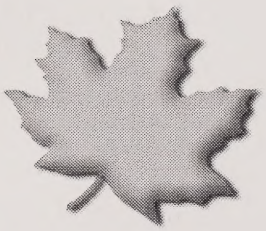

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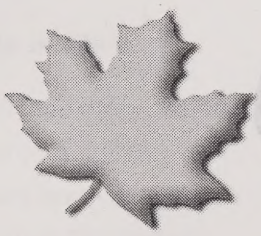
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Report on the Management of Canada's Official International Reserves

2003

Canada



Report on the Management of Canada's Official International Reserves

2003

Department of Finance Canada
Ministère des Finances Canada



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Purpose of the Report

This report reviews the operations of the Exchange Fund Account (EFA) for the 2003 calendar year. The EFA is the main repository of Canada's official international reserves and is the only actively managed portfolio of reserves.

The EFA is governed by the provisions of the *Currency Act*, which states that the Minister of Finance shall report to Parliament on the operations of the EFA for each calendar year within five months after the end of that year.

The report provides a comprehensive account of the context within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide additional information on the year-end financial position and annual changes of the EFA.

What Is the Exchange Fund Account?

The EFA is the principal repository of Canada's official international reserves. It is maintained to provide general foreign currency liquidity for the Government of Canada and to provide a source of funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

The Exchange Fund Account as at December 31, 2003

	(market value in millions of US dollars)
Securities	29,421
Deposits	2,005
Gold	45
Special drawing rights	838
Total	**32,309**

The EFA's assets are funded by foreign currency liabilities. Assets and liabilities are managed on a portfolio basis and are matched as closely as possible in currency and duration to minimize exposure to currency and interest rate risks.

Canada's official international reserves stood at US$36.3 billion as of December 31, 2003, composed of the EFA (US$32.3 billion), foreign currency accounts held by the Bank of Canada (US$106 million) and the Receiver General (US$5 million), and the reserve position in the International Monetary Fund (US$3,848 million).

Highlights of 2003

During 2003 notable developments were:

- As at December 31, 2003, official international reserves, at US$36.3 billion, were slightly lower than the reserve levels of US$37.2 billion as of December 31, 2002. This is explained by large foreign currency debt maturities met through sales of assets, which were partly offset by foreign currency revaluations resulting from the appreciation of the euro against the US dollar. There was no change arising from intervention in foreign exchange markets during the year.
- The structure of the EFA portfolio was managed to limit the cost of carrying assets. During 2003, taking into account net interest costs of US$19 million and US$278 million in gains on asset sales, the Government earned net revenues of US$259 million.
- Consistent with the Government's policy to immunize currency and interest risks in Canada's reserve portfolio, the amount of foreign currency assets was brought into line with liabilities. Foreign currency liabilities had exceeded foreign currency assets in recent years, largely as a result of foreign exchange intervention in support of the Canadian dollar in 1998.
- An external evaluation of the management of the Government's reserves concluded that Canada's practices compare well with those of other sovereigns and private financial institutions. The evaluation and the departmental response to the recommendations were tabled in Parliament and submitted to the Office of the Auditor General. It is also available upon request from the Department of Finance.
- In line with continued efforts to increase transparency and to stay at the forefront of sovereign practice, the Government published its investment and credit guidelines governing the EFA portfolio on the Department of Finance Web site (www.fin.gc.ca/efa/EFAGuidelines_e.html).
- A new framework was implemented to move a portion of the Government's short-term US-dollar deposits to a collateralized basis by introducing a US-dollar repo program. As a result, the Government's credit risk to financial institutions has been reduced significantly.
- The last of the Government's gold bullion was sold in December 2003. Proceeds from gold sales over the last 20 years have been invested in interest-bearing assets, raising the return for the EFA by US$13 billion more than would have been the case had the Government maintained its gold holdings. Of note, the Government continues to hold gold coins.
- The Government implemented a new governance framework. The new framework enhances coordination between the Department of Finance and the Bank of Canada in the area of funds and risk management of the Government's debt and reserves. The framework will enhance decision making and risk management of the EFA within the overall strategy approved by the Minister.

Section I: Overview of the Exchange Fund Account

The Exchange Fund Account is the main repository of Canada's official international reserves and is the component that is actively managed by the Government. It is composed of securities (bonds and bills issued by a sovereign, an agency or an international financial organization) and bank deposits denominated in foreign currencies, gold and special drawing rights (SDRs).[1]

Purpose of the EFA

The purpose of the EFA is to provide general foreign currency liquidity for the Government and to provide a source of funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

Principles and Objectives

The following principles and objectives guide the management of the EFA:

- Prudence: Maintain an appropriate level of reserves invested in high-quality and highly liquid assets. Manage reserves within a framework that matches foreign liabilities to reserve assets to immunize currency and interest rate risk, and that controls credit risk through diversification and collateral management frameworks.
- Cost-effectiveness: Minimize the cost of carrying reserves (i.e. the difference between interest paid on foreign currency liabilities and interest earned on reserve assets).
- Consultations: Seek input from market participants on major adjustments to the foreign reserves management program.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Governance Framework

The EFA is governed by the provisions of the *Currency Act*, which states that the Minister of Finance shall report to Parliament on the operation of the EFA each calendar year within five months after the end of that year.

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[1] An SDR is an international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

The Government approves the general policies related to the management of the EFA and, in particular, establishes the target level of reserves and provides an annual report to Parliament on the operations of the EFA. The Department of Finance and the Bank of Canada share responsibility for the management of the EFA. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

In 2003 the Government implemented a new governance framework for its funds management, including the EFA and risk management. Further information on governance is provided in Section II.

EFA Assets

The Level of Reserves

As at December 31, 2003, the level of official international reserves stood at US$36.3 billion and the EFA totalled US$32.3 billion. Reserves are reported on a market value basis. The value of reserves fluctuates due to both external factors (e.g. changes in exchange rates and interest rates) and actions by managers (e.g. an increase in investments). Further information on the sources of changes in reserves can be found in Section II.

Structure and Composition

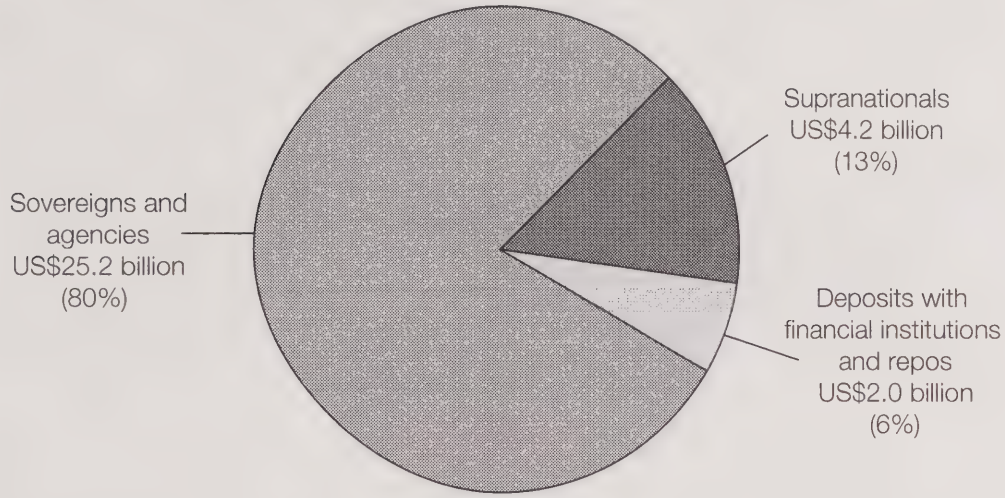
Structure

The EFA is structured into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the Government's core liquidity requirements in foreign currencies. It consists of highly rated US-dollar-denominated marketable short-term (under one year) assets, such as discount notes and bank deposits. The Investment Tier consists of a diversified mix of highly rated liquid bonds denominated in US dollars, euro and yen.

Eligible EFA Investments

The Government can invest in securities (bonds and bills) issued by a sovereign, an agency or an international financial organization. Reserves can also be invested in US-dollar cash deposits with financial institutions or in US-dollar repos. Further information on the Government's repo program can be found in Section II. As indicated in Chart 1, the majority of reserves were invested in securities issued by sovereigns and agencies as at December 31, 2003.

Chart 1
EFA Investments by Issuer
as at December 31, 2003



Note: Numbers may not add due to rounding.

Currency Composition

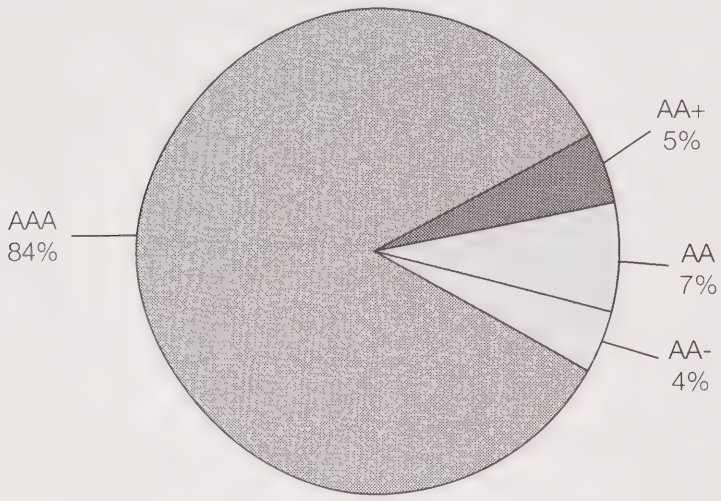
The EFA can hold investments denominated in three currencies: US dollars, euro and yen. About 50 per cent of the EFA is denominated in US dollars. This reflects the fact that foreign currency needs are mostly in US dollars and that, historically, foreign exchange intervention has taken place primarily in the Canadian/US-dollar exchange market. The remainder of the EFA is split between the euro and the yen, depending on investment opportunities in these markets. As at December 31, 2003, the US-dollar share of the portfolio was US$15.6 billion (or 49.4 per cent), the euro share was 11.9 billion euros (or 47.3 per cent) and the yen portion was 112.5 billion yen (or 3.3 per cent).[2] A more detailed breakdown of the EFA by currency is provided in Section II.

Eligible Credit Ratings

To be eligible for EFA investments, an entity must have a credit rating of at least A- (see guidelines in Annex 2 for details). The majority of EFA investments are in the AAA category, as indicated in Chart 2.

[2] Based on an ongoing assessment of needs, the US-dollar share is maintained at about US$15 billion, plus or minus an operating range, with the remainder of the EFA portfolio in euro and yen assets.

Chart 2
EFA Investments by Credit Rating
as at December 31, 2003



Risk Management

The Government has a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of its foreign exchange reserves. The main elements of this framework are outlined below.

Asset-Liability Management Framework

The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis. The Government follows an "asset-liability management framework," whereby assets and liabilities financing these assets are matched (as closely as possible) in currency and duration, so that the Government is not exposed to significant currency and interest rate risks.

Investment and Credit Guidelines

The management of reserves is governed by investment and credit guidelines approved by the Minister of Finance (see Annex 2). The guidelines, which encompass all lines of business, limit the Government's credit exposure and call for diversification of assets and counterparties. In addition, high liquidity standards are defined in the guidelines. For instance, to ensure that reserves are invested in liquid securities, the outstanding amount of securities must be at least US$500 million. There are also rules governing the maximum maturity of reserve assets.

Collateral Management Frameworks

Collateral management frameworks are used to manage the Government's credit risk to financial institution (FI) counterparties associated with cross currency swaps, forward contracts and commercial deposits. Under these frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when credit risk to FI counterparties exceeds specified limits.

Governance

The governance framework (see Section II) ensures that risk issues are identified and addressed. A Risk Committee meets regularly to review risk reports and to provide guidance and accountability on the Government's treasury risk policies. The Financial Risk Office at the Bank of Canada, jointly established with the Department of Finance, monitors and advises on the risk position of the Government. All aspects of risk management (from market to operational and legal risks) are regularly reviewed by the Risk Committee.

Operational Risk

Operational risk results from deficiencies in information systems and internal controls or from human error, which can result in unexpected loss. The Bank of Canada, as the Government's fiscal agent for debt and reserves management, has put in place a number of initiatives to mitigate operational risk. For instance, the Bank of Canada regularly analyzes operational processes, establishes controls and closely monitors employee turnover and changes in the skill mix of the staff. In addition, indicators of sources of risks have been developed and are closely monitored.

Legal Risk

Legal risk is the risk of loss because of the application of a law or regulation or because a contract cannot be enforced. Legal risk is controlled with the same methods used in the private sector, essentially through proper documentation of all business operations to clarify the rights and obligations of each party. A legal risk review is undertaken periodically to identify any potential issues with respect to existing documentation or other legal risk issues.

Section II: Exchange Fund Account Operations in 2003

Major Initiatives in 2003

In 2003 key initiatives focused on strengthening the Government's risk management framework and enhancing transparency. In addition, an external review of the Government's management of the EFA was undertaken.

Closing the Asset-Liability Gap

Action was taken in 2003 to reduce currency and interest rate risk in Canada's reserve portfolio. In the 1990s foreign currency liabilities came to exceed liquid foreign currency assets, largely as a result of foreign exchange intervention and payments to the IMF. The Government took steps to bring foreign currency liabilities in line with foreign currency assets through a program of purchases of US dollars in foreign exchange markets starting in 1998. In 2003 the Government eliminated the gap between foreign currency assets and liabilities, thereby reducing its exposure to market risk, i.e. both interest and exchange rate risk.

US-Dollar Repo Program[3]

Until April 2003, US-dollar cash balances were invested in unsecured bank deposits with a number of commercial banks. A program of investments in the repo market has been implemented to collateralize approximately one-quarter of the Government's short-term US-dollar investments, consequently reducing the Government's portfolio of unsecured bank deposits.

A New Governance Framework

In October 2003, the Government introduced a new governance framework for its funds management, including the EFA. Under the new framework, a Funds Management Committee (FMC), which meets semi-annually, comprises senior management of the Department of Finance and the Bank of Canada. The FMC's mandate is to advise the Minister on policy and strategy for funds and risk management, oversee the implementation of approved policy and plans, and review performance outcome reports. The responsibilities of the FMC include advising on the target level of the reserves, target liquidity position, intervention guidelines, borrowing program plans and implementation; conducting program reviews; and approving new initiatives for recommendation to the Minister.

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[3] Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a prespecified price at a predetermined future date. These transactions are similar to secured loans, with the lender of the money receiving securities as collateral as protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

The FMC is supported by the Risk Committee, whose mandate is to oversee and advise on the development and implementation of risk management policy and strategy in line with best practices. The Financial Risk Office (formerly the Risk Management Unit) supports the Risk Committee in this role and is also responsible for monitoring and controlling the risk position of the EFA, including market, credit, operational, liquidity and legal risks.

Increased Transparency

In 1999 the Government of Canada was one of the first countries to provide enhanced reserves disclosure in a manner consistent with the standards established by the IMF and the G-10 central banks. In line with continued global efforts to increase transparency, the Government disclosed its investment and credit guidelines governing the EFA portfolio in April 2003 on the Department of Finance Web site (www.fin.gc.ca/efa/EFAGuidelines_e.html). With the disclosure of these guidelines, Canada has become one of the most transparent countries with regard to reserves management. The guidelines can also be found in Annex 2.

External Evaluation of EFA Management

As part of the Debt Program Evaluation Program, an external evaluation of the management of the Government's reserves, including risk management practices, was undertaken in 2003. The evaluation noted considerable strengths in the management of reserves, and that Canada's practices compare well with the best practices of other sovereigns and private financial institutions. A number of enhancements to the program (e.g. the development of an optimization analytical tool to manage effectively both assets and liabilities within the portfolio framework) were proposed and the Government is following up. The report was forwarded to the parliamentary Standing Committee on Public Accounts and the Office of the Auditor General in August 2003 and is available upon request from the Department of Finance.

Completion of Canada's Gold Bullion Sales Program

In 1980 the Government implemented a policy of selling its gold at a gradual and controlled pace to enhance the return for the EFA. Proceeds from gold sales were invested in interest-bearing foreign currency assets. In December 2003 the Government sold its last gold bullion. This policy has greatly benefited Canadians. Since the start of the gold sales program in 1980, reserve asset income has been US$13 billion higher than it would have been had the Government maintained its gold bullion. As at the end of December 2003, the Government's remaining gold reserves were composed entirely of gold coins.

The Market Environment in 2003

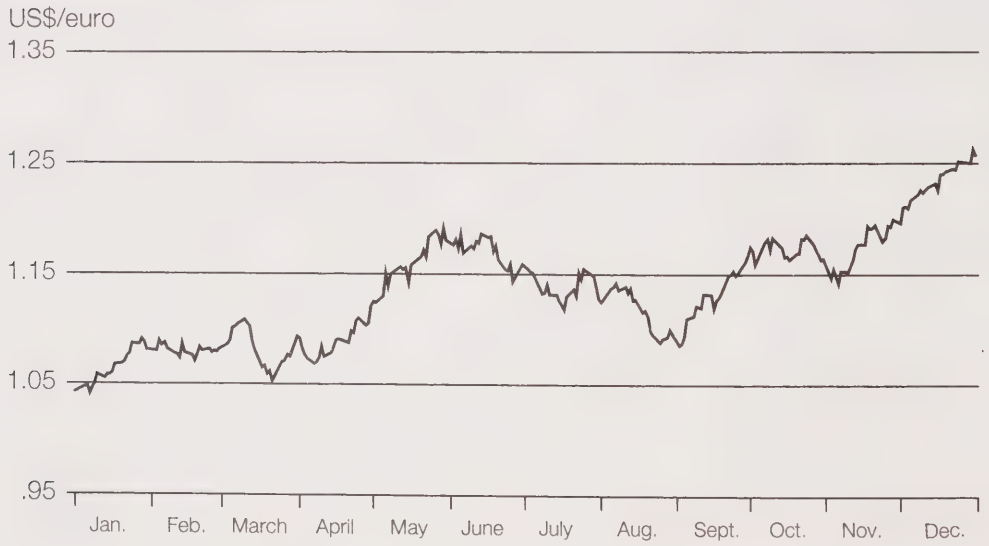
As reserves are reported on a market value basis and in US dollars, changes in exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates) and interest rates will affect the level of the EFA.

Developments in Foreign Exchange Markets[4]

As up to 50 per cent of reserves were held in euro-denominated securities during 2003, the EFA's market value has been affected by movements in the euro (see Chart 3). The euro finished 2003 up 20.6 per cent from the previous year. It reached a high of 1.2609 (US dollar/euro) on December 30, 2003, while the low for the year was 1.0396 on January 7, 2003.

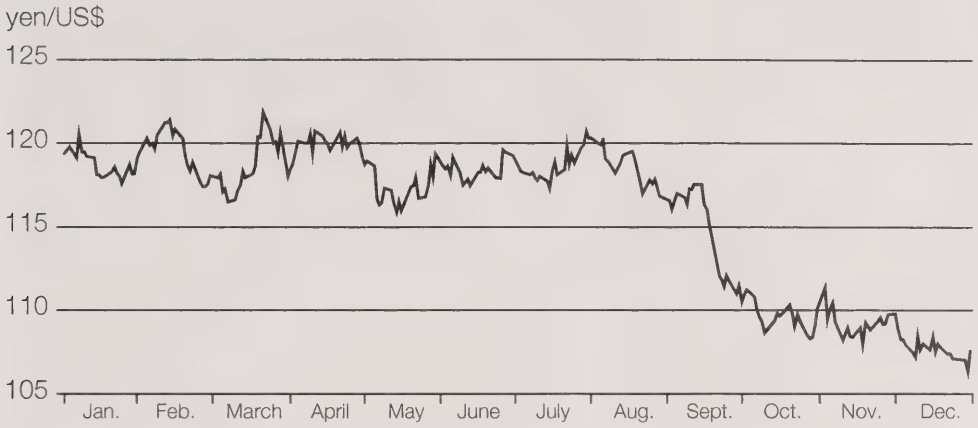
The EFA is less subject to changes in the yen/US-dollar exchange rate (see Chart 4) since only 3.3 per cent of reserves are held in yen-denominated assets (as at December 31, 2003). During 2003 the yen appreciated by 9.97 per cent against the US dollar. The high for the year was 106.25 on December 30, 2003, and the low was 121.74 on March 21, 2003.

Chart 3
The Evolution of the Euro in 2003



[4] Charts 3 and 4 show the market standard for cross rates, where the euro is quoted in US-dollar terms (i.e. the amount of US dollars required for 1 euro) and the yen is quoted in yen terms (i.e. the amount of yen required to buy 1 US dollar). Both charts reflect a decline in the US dollar.

Chart 4
The Evolution of the Yen in 2003



Developments in Interest Rates

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the price of the investments held in the EFA. Movements in interest rates had little impact on the EFA during 2003 compared to movements in exchange rates. The market value of the EFA declined by US$292 million due to changes in interest rates, whereas foreign currency revaluations increased the market value of the EFA by US$3.0 billion.

Changes in the Level of Reserves

As shown in Table 1, Canada's official reserves as at December 31, 2003, were US$36.3 billion (on a market value basis), down from US$37.2 billion as at December 31, 2002. The decrease in the reserves level during 2003 was in large part due to the use of assets to meet maturing liabilities. The sources of changes in reserves are detailed in the next section.

Table 1

Canada's Official International Reserves Holdings as at December 31

		Foreign currency accounts held by:					
	2002 total	EFA	Bank of Canada	Minister of Finance	Receiver General	2003 total	Change
	(market value in millions of US dollars)						
Securities	30,240	29,421	–	–	–	29,421	-819
Deposits	2,445	2,005	106	–	5	2,116	-329
Gold	205	45	–	–	–	45	-160
Reserve position in the IMF	3,567	–	–	3,848	–	3,848	281
Special drawing rights	712	838	–	–	–	838	126
Total	**37,169**	**32,309**	**106**	**3,848**	**5**	**36,268**	**-901**

Sources of Changes During 2003

As shown in Table 2, the level of reserves fell by US$901 million during 2003 due to large maturities and foreign currency debt-servicing costs.[5] However, the decline was partly offset by foreign currency revaluation, which was mainly due to the appreciation of the euro versus the US dollar.

The level of reserves changes over time due to a variety of factors.

Foreign Exchange Market Intervention

Intervention in the Canadian foreign exchange market has not occurred since 1998 (see Annex 1). Intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and therefore affects the level of the EFA.

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements and for additions to reserves will affect the EFA. Foreign exchange requirements exceeded purchases by US$60 million.

Reserves Management Operations

Debt maturities and purchases of foreign currency assets affect the level of the EFA. Foreign currency assets are purchased with the proceeds of foreign currency issuance (including cross currency swaps). Large maturities (i.e. US$3.7 billion in total, of which over half was due to the maturity of a US$2.0-billion global bond in February 2003) contributed the most to the decline in the level of reserves.

[5] The Government's policy to manage both assets and liabilities on a portfolio basis minimizes net debt-servicing costs. During 2003 the EFA portfolio was in a net liability position in the first half of the year. The gap between foreign currency assets and liabilities was closed as of June 2003.

Gains and Losses on Gold Sales

This factor reflects the degree to which proceeds from the sales of gold exceed the market value of gold that existed at the end of the previous month. Losses on gold sales slightly exceeded the gains, i.e. by US$8 million. The last of the Government's gold bullion was sold in December 2003.

Return on Investments

Return on investments comprises interest earned on investments (US$1,154 million) and changes in the market value of securities resulting from changes in interest rates (-US$292 million). The overall effect on the EFA was a net increase of US$862 million.

Net Foreign Currency Debt-Servicing Costs

Net foreign currency debt-servicing costs reduced the level of the EFA by US$1.3 billion.

Foreign Currency Revaluations

Revaluation effects reflect changes in the market value of reserve assets resulting from movements in exchange rates. During 2003 foreign currency revaluations increased reserves by US$3.0 billion, primarily due to the appreciation of the euro versus the US dollar.

Table 2

Sources of Changes in Canada's Official International Reserves During 2003

	Value of change
	(market value in millions of US dollars)
Foreign exchange market intervention	0
Net government operations	-60
Reserves management operations	-3,673
Gains and losses on gold sales	-8
Return on investments	862
Net foreign currency debt-servicing costs	-1,299
Foreign currency revaluations	3,043
Other transactions[1]	234
Total change	**-901**

[1] Include increased support for IMF lending operations.

More detailed information on monthly levels and changes in Canada's reserves is provided in Annex 3.

Composition of the Asset Portfolio

Table 3 shows liquid EFA investments by currency and term to maturity. As at December 31, 2003, US-dollar holdings made up about half of the portfolio. They were dominated by relatively short- (i.e. under six months) and medium-term (i.e. one to five years) maturities as they are held for liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards the longer end of the yield curve, with the majority being medium- and long-term (i.e. over five years) investments. The yen holdings were also mostly invested in securities with medium- and long-term maturities. Over 2003, total euro holdings grew by US$1.1 billion, largely as a result of the appreciation of the euro versus the US dollar. Yen assets increased marginally across maturities, maintaining its maturity profile, due to the appreciation of the yen versus the US dollar.

Table 3

Term Structure of Liquid Foreign Currency Investments as at December 31[1]

Term	2002 total assets	Cash and term deposits	Government securities in domestic currency	Other securities	2003 total assets	Change
	(market value in millions of US dollars)					
US-dollar holdings						
Under 6 months	8,898	1,916	3,195	1,735	6,846	-2,052
6 to 12 months	31	–	–	1,315	1,315	1,284
1 to 5 years	5,848	–	–	5,662	5,662	-186
Over 5 years	3,068	–	–	1,652	1,652	-1,416
Total US-dollar holdings	17,845	1,916	3,195	10,364	15,475	-2,370
Euro holdings[2]						
Under 6 months	175	12	239	303	554	379
6 to 12 months	322	–	949	–	949	627
1 to 5 years	4,937	–	5,927	1,147	7,074	2,137
Over 5 years	8,335	–	5,409	917	6,326	-2,009
Total euro holdings	13,769	12	12,524	2,367	14,903	1,134
Yen holdings						
Under 6 months	69	77	–	–	77	8
6 to 12 months	–	–	–	–	–	–
1 to 5 years	429	–	472	–	472	43
Over 5 years	462	–	499	–	499	37
Total yen holdings	960	77	971	–	1,048	88
Total	**32,574**	**2,005**	**16,690**	**12,731**	**31,426**	**-1,148**

[1] Liquid foreign currency investments represent the securities and deposits held in the EFA and excludes SDRs and gold holdings.

[2] The respective December 31 exchange rates were used for the euro and yen assets.

Financing

The EFA foreign currency reserves are financed by foreign currency borrowings by the Government (see Table 4). Currently all foreign currency marketable assets are matched to foreign currency borrowings.

The Government borrows in foreign currencies exclusively to raise foreign exchange reserves for the EFA. Borrowing requirements for foreign exchange reserves are generally met through cross currency swaps of domestic obligations, which are highly cost-effective compared to other sources of foreign currency funds. Canada bills, Canada notes, Euro Medium-Term Notes (EMTNs) and global bonds may also be used, depending on the funding needs and market conditions.

During 2003 the level of outstanding Canada bills decreased slightly (by US$60 million). There were no new issuances of Canada notes, EMTNs or global bonds. One US-dollar global bond (US$2.0 billion) matured and the total cross currency swap issuances and maturities were US$0.7 billion and US$2.3 billion respectively.

Increases shown for EMTNs and Canada notes are due only to the exchange rate appreciation of the euro and yen versus the US dollar (as reserves are reported in US dollars).

Table 4

Foreign Currency Issues as at December 31

	2002	2003	Change
	(par value[1] in millions of US dollars)		
Global bonds	11,410	9,896	-1,514
Canada bills	1,712	1,652	-60
Swapped domestic issues	18,378	18,456	78
Canada notes	842	931	89
Euro Medium-Term Notes	2,161	2,413	252
Total	**34,503**	**33,348**	**-1,155**

[1] Liabilities are stated at the respective years' December 31 exchange rate.

Revenues

The EFA's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 2003 the EFA's income totalled C$2,963 million, compared with C$2,728 million during 2002.

The main categories of income earned by the EFA are summarized in Table 5. Data is reported in Canadian dollars, as the EFA statements of revenues in the attached financial statements are reported in Canadian dollars.

Table 5
Revenues

	2002	2003	Change
	(millions of Canadian dollars)		
Investment income			
Marketable securities	2,110	1,931[1]	-179
Cash and short-term deposits	91	49	-42
Special drawing rights	23	21	-2
Gold	4	–	-4
Total investment income	2,228	2,001	-227
Other income			
Gains on gold sales	175	205	30
Foreign exchange gains (losses)	325	757	432
Total income	**2,728**	**2,963**	**235**

[1] Includes income from securities lending.

The EFA's securities-lending program enhances the yield earned on the portfolio by lending out to counterparties securities that are highly sought after in the market. At year end, US$2.3 billion (par value) in US government securities were held by the two financial institutions that act as agents for lending these securities to market participants. Income from securities lending, included in income from marketable securities, totalled US$1.0 million during 2003 compared to US$0.6 million during 2002.

The EFA lends gold in the market on a short-term basis, occasionally using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans. Income from this activity is reported as investment income on gold. Given that the last of the bullion was sold at the end of 2003, this source of income will be removed during 2004.

Net Cost of the EFA

One objective in managing the EFA is to minimize the cost of carrying reserves. The Account must be invested in liquid high-quality fixed-income securities, which provide a relatively low rate of return. In recent years policy changes have been taken to broaden the eligible asset mix, within prudent limits, and to invest more in euro-denominated assets. These measures have helped to increase portfolio returns. Further means used to minimize the carry of the EFA have been the use of cross currency swaps, which are highly cost-effective compared to other sources of funds. The EFA's carry has been further improved by proceeds derived from the securities-lending program.

The EFA's cost of carry is currently estimated by subtracting the interest paid on Canada's foreign currency liabilities from interest earned on the EFA's assets (i.e. net interest earned or paid). It does not include realized gains/losses or revaluation effects on assets and liabilities. Work is underway to develop a new measure of portfolio performance for 2004 that will include realized and unrealized gains/losses in addition to net interest income.

Table 6 provides an estimate of the net interest cost of carry for the EFA portfolio as a whole and for segments of the portfolio. The carry of the total EFA portfolio during 2003 is estimated at -6 basis points, a level that is lower than what it would have been had the Government not sold older assets for newer issues (during the year, older, higher-yielding securities were switched into newer issues offering lower yields while maintaining a matched asset/liability portfolio, and interest rates payable on liabilities remained at a level near that of previous years.)[6] However, the reduction in interest earnings was offset by realized market value gains on the securities sold. When the realized gains are taken into consideration, the overall gain is estimated at +96 basis points. (The EFA realized US$131 million in gains on US-dollar asset sales, and US$147 million in gains on euro asset sales. These gains were accumulated over several years, and were realized in 2003 when the assets were sold.)

Table 6

Carry for the EFA During 2003

	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Average value of assets	Carry in basis points[1]	Carry in basis points (including net realized gains)
			(millions of US dollars)			
Euro portfolio	615.5	608.2	7.3	13,225.1	+2	+45
Yen portfolio	10.8	11.3	(0.5)	941.1	0	0
US$ portfolio	525.8	565.6	(39.8)	16,278.4	-12	+47
Subtotal	1,152.1	1,185.1	(33.0)	30,444.6	-10	+92
IMF position[2]	66.7	52.4	14.3	3,527.2	+4	+4
Total	**1,218.8**	**1,237.5**	**(18.7)**	**33,971.8**	**-6**	**+96**

[1] The carry figures show the contribution of each currency portfolio to the overall carry of the EFA.

[2] Interest earned on Canada's reserve position in the IMF and SDR holdings. Interest paid includes interest paid on Canada's cumulative allocation of SDRs, plus interest paid on a portion of the US-dollar floating-rate liabilities; it is assumed that the IMF position is partially funded by these liabilities.

[6] As US interest rates reached 45-year lows in 2003, coupons attached to interest-bearing bonds issued in 2003 were generally lower compared to bonds issued in previous years. Since older securities were redeployed into newer issues (with smaller coupons) in 2003, the interest earned on US-dollar assets is lower than in previous years.

Annex 1: Foreign Exchange Market Intervention

Since September 1998 the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[7] Since that time its only market intervention was the purchase of euros in 2000 as part of Canada's participation in the G-7 concerted intervention in support of the euro, as shown in Table 7.

Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy; the goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary. A more detailed description of foreign exchange market intervention can be found on the Bank of Canada's Web site (www.bankofcanada.ca/en/backgrounders/bg-e2.htm).

Table 7
Foreign Exchange Market Intervention

	1999	2000	2001	2002	2003
			(millions of US dollars)		
Purchases	0	97	0	0	0
Sales	0	0	0	0	0
Net	**0**	**97**	**0**	**0**	**0**

[7] Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

Annex 2: Investment and Credit Guidelines for the EFA

I. Eligible Issuers

To be eligible for EFA investments, an entity must have a credit rating in the top seven long-term categories from at least two of the following four rating agencies, at least one of which must be either Moody's Investors Service or Standard & Poor's:

Ratings agency	Minimum rating
Moody's Investors Service	A3 or better
Standard & Poor's	A- or better
Fitch Ratings	A- or better
Dominion Bond Rating Service	A (low) or better

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

II. Aggregate and Individual Limits on Holdings

a) Sovereigns and Directly Guaranteed Agencies

Type of issuer	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies) and AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
Single-A sovereigns (including directly guaranteed agencies)	2	See below[1]

[1] *The limits for single-A sovereigns (including directly guaranteed agencies) are as follows:*

Credit rating	Total exposure	Of which home currency	Of which non-home currency
	(millions of US dollars)		
A+	500	500	50
A	250	250	25
A-	100	100	10

b) Other Eligible Securities/Deposits

Type of issuer/ financial institution	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
Implicitly guaranteed sovereign agencies (including eligible US agencies)	15	3
Supranationals (not including deposits at the BIS)	25	10
Deposits at the BIS	10	–
Commercial bank deposits	US$1.5 billion	See limits below

III. Financial Institution (FI) Counterparty Credit Risk Limits

a) For Swaps, Deposits and Forwards

	Credit rating of FI counterparty						
Type of exposure	A-	A	A+	AA-	AA	AA+	AAA
	(millions of US dollars)						
Actual exposure	10	25	50	100	150	200	300
Aggregate actual exposure for all FI counterparties	2% of liquid reserves			n/a	n/a	n/a	n/a
	25% of liquid reserves						
Total potential exposure for all FI counterparties	1,250						

b) For Repo Transactions

Minimum credit rating for a counterparty	A-	
Business line limits for counterparties, by credit rating	AAA	US$750 million
	AA	US$500 million
	A	US$300 million
Eligible collateral	US treasuries and agencies	
Minimum rating for collateral	AAA	
Maximum term of collateral	10.5 years	

IV. Terms of Investments

Instrument	Maximum term
Commercial bank deposits and other non-marketable investments	3 months
Commercial bank marketable investments	1 year
Single-A sovereign investments	
In local currency	5 years
In foreign currency	1 year
All other marketable securities	10.5 years (unless matching a specific liability that exceeds 10.5 years)

V. Liquidity Limits

Minimum holdings of US treasuries	10% of liquid reserves
Minimum issue size	US$500 million
Maximum holding of any issue/note program/commercial paper (CP) program	10% of the issue/note program/CP program
Maximum non-marketable investments beyond 5 days in term	15% of liquid reserves

VI. Currency Composition Guideline

Currency	Portion of liquid reserves
US dollar	US$15 billion, subject to an operating range
Euro and/or yen	Remainder of the EFA

Annex 3: Canada's Official International Reserves

Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change	Reserves management operations[4]	Gains and losses on gold sales	Return on investments[5]	Foreign currency debt charges	Revaluation effects	Net government operations[6]	Official intervention	Other transactions[7]
						(market value in millions of US dollars)									
2002															
December	30,240	2,445	205	712	3,567	37,169	668	-692	-1	444	-195	855	257	0	0
2003															
January	29,377	3,719	220	728	3,591	37,635	466	-44	0	127	-33	423	-16	0	9
February	28,160	3,266	177	738	3,560	35,901	-1,734	-2,030	-5	283	-107	34	0	0	91
March	27,946	3,309	170	739	3,762	35,926	25	84	0	-102	-165	165	0	0	43
April	28,819	2,813	142	745	3,744	36,263	337	-30	-1	94	-66	340	0	0	0
May	30,377	2,319	153	777	3,797	37,423	1,160	-85	0	458	-104	847	-1	0	45
June	29,213	2,463	107	766	4,150	36,699	-724	-29	-2	-2	-213	-395	0	0	-83
July	28,771	2,027	110	761	4,096	35,765	-934	-126	0	-366	-152	-376	-43	0	129
August	28,575	2,100	65	765	3,785	35,290	-475	-111	1	-24	-26	-315	0	0	0
September	29,095	2,751	67	794	3,971	36,678	1,388	36	0	394	-83	1,041	0	0	0
October	29,258	1,789	67	795	3,947	35,856	-822	-399	0	-222	-120	-81	0	0	0
November	28,671	2,573	69	812	3,968	36,093	237	-215	0	-19	-47	518	0	0	0
December	29,421	2,116	45	838	3,848	36,268	175	-724	-1	241	-183	842	0	0	0
Total	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**-901**	**-3,673**	**-8**	**862**	**-1,299**	**3,043**	**-60**	**0**	**234**

[1] Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

[2] Special drawing right (SDR)-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

[3] The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

[4] Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

[5] Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

[6] Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

[7] Other transactions cover increased support for IMF lending operations.

Annex 4: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through Chase Manhattan Bank in New York City. Primary distribution occurs through five dealers: CIBC Wood Gundy Inc., Credit Suisse First Boston Corporation, Goldman, Sachs & Co., Lehman Brothers Inc. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston Corporation, Goldman, Sachs & Co., Lehman Brothers Inc., Nesbitt Burns Securities Inc. and Scotia Capital Markets (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

cross currency swap: An agreement that exchanges one type of return for another (e.g. a fixed for a floating rate of interest) and the principal amount for the term of the swap. Cross currency swaps of domestic obligations are a cost-effective alternative to foreign-currency-denominated bond issues as a means of meeting the Government's targets for longer-term foreign currency funding.

Euro Medium-Term Note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley Dean Witter. The London-based dealer group includes CIBC World Markets plc, Goldman Sachs International and J.P. Morgan Securities Ltd. among others. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars.

repo; repurchase agreement: A transaction in which a party sells a security and simultaneously agrees to repurchase it at a given price after a specified time.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is often collateralized. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

Exchange Fund Account

Management Responsibility for the Financial Statements

Responsibility for the Financial Statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The Financial Statements were prepared in accordance with the stated accounting policies set out in Note 2 to the Financial Statements, which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and for related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the Financial Statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the Financial Statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the Financial Statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

W. P. Jenkins

Paul Jenkins
Senior Deputy Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey

S. Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada

Auditor's Report

To the Minister of Finance

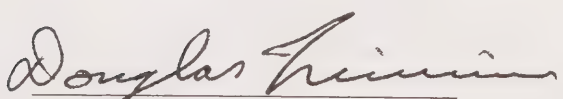
I have audited the balance sheet of the Exchange Fund Account as at December 31, 2003 and the statement of revenue for the year then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2003 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.



Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 12, 2004

Exchange Fund Account

Balance Sheet as at 31 December 2003

	2003		2002	
	US	Canadian	US	Canadian
		(millions of dollars)		
Assets				
Denominated in US dollars				
Cash and short-term deposits	2,277	2,952	2,529	3,990
Marketable securities (Notes 5 and 6)	12,812	16,611	14,635	23,088
	15,089	19,563	17,164	27,078
Denominated in other foreign currencies				
Cash and short-term deposits (Note 7)	89	116	134	211
Marketable securities (Notes 5 and 7)	15,261	19,786	13,899	21,928
	15,350	19,902	14,033	22,139
Denominated in Special Drawing Rights				
Special drawing rights (Note 8)	842	1,090	719	1,134
Gold and gold loans (Note 9)	6	7	28	45
	848	1,097	747	1,179
Official international reserve assets	31,287	40,562	31,944	$ 50,396
Due to the Consolidated Revenue Fund				
Advances (Note 10)		37,599		47,668
Net revenue for the year		2,963		2,728
		40,562		**50,396**

Approved:

W. P. Jenkins

Paul Jenkins
Senior Deputy Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey

S. Vokey, CA
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Revenue
Year Ended 31 December 2003

	2003	2002
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,931	2,110
Cash and short-term deposits	49	91
Special drawing rights	21	23
Gold	–	4
	2,001	2,228
Other revenue		
Net gain on sales of gold	205	175
Net foreign exchange gains	757	325
	962	500
Net revenue for the year due to the Consolidated Revenue Fund	**2,963**	**2,728**

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to the Financial Statements
Year Ended 31 December 2003

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Account are to provide general liquidity for the government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling/buying foreign currencies / buying/selling Canadian dollars when there were market forces on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Revenue for the year is payable to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in accordance with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances. The advances are provided interest free under the terms and conditions prescribed by the Governor in Council and the Account reflects only transactions pertaining to the assets of the Account. The significant accounting policies of the Account are set out below.

a) Basis of Presentation

The purpose of the financial statements is to report to Parliament on the operations of the Account to comply with the *Currency Act*. The Bank of Canada, on behalf of the Minister of Finance, may sell, lend, borrow, or deal in assets under

the terms and conditions prescribed by the *Currency Act*. The reporting entity of the Account is limited to those transactions permitted by the *Currency Act* and to the category of expenses determined by the Minister as authorized by legislation. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

All expenses determined by the Minister to have been incurred in respect of the operations of the Account are paid out of the Account. This excludes the cost of administrative, custodial, and fiscal- agency services that are provided by the Bank of Canada with regard to the transactions in the Account and that are not recognized in the financial statements.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Governor in Council.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

All material changes in cash flows are evident from the financial statements. A separate statement of cash flows has not been prepared.

b) Valuation of Assets

The estimated fair market value of cash, short-term deposits, and special drawing rights (SDRs), which are recorded at cost and generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs, including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and SDRs include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies.

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*.

c) Revenue from Investments

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, revenues from gold loans, and revenues from securities-lending activities. Writedowns of securities to their year-end market values (if applicable) are netted against investment revenue in the year in which they occur.

d) Gold

Net gains on gold sales are recorded at settlement dates and are included in the category *Other revenue* in the *Statement of Revenue*. Interest revenue from gold loans is recorded on an accrual basis and premiums on the sales of call options on gold are recorded when received. Both are included in category *Revenue from investments* in the *Statement of Revenue*.

e) Tri-party Reverse Repurchase Agreement

In 2003, tri-party reverse repurchase transactions were implemented. Tri-party reverse repurchase trades are money market transactions where the Account lends funds on a secured basis to designated counterparties at prevailing market rates. The collateral on these transactions is held by a tri-party custodian. Tri-party reverse repurchase transactions are recorded on the balance sheet under the category *Cash and short-term deposits*. They include amounts at which the securities were originally loaned plus the accrued interest. Revenue from these transactions is included in the category *Revenue from investments* in the *Statement of Revenue*.

f) Translation of Foreign Currencies and SDRs

Assets and advances denominated in foreign currencies and SDRs are translated into Canadian and US-dollar equivalents at year-end market exchange rates, which were as follows:

	2003	2002
	(Canadian dollars)	
US dollars	1.2965	1.5776
Euros	1.6282	1.6568
Japanese yen	0.01207	0.01328
Special drawing rights	1.92656	2.13699

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year, are recorded as net foreign exchange gains and are included in the category *Other revenue* in the *Statement of Revenue*. Unrealized foreign exchange gains or losses on forward currency contracts are also recorded in revenue as net foreign exchange gains.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar or to meet net government requirements for foreign exchange. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority, but not all, of Canada's official international reserves reside inside the Account. The Account represents approximately 89 per cent (90 per cent in 2002) of Canada's official reserves.

4. Risk Management and Financial Instruments

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the Account asset portfolio is prudently diversified with respect to credit risk, the investment guidelines specify limits on holdings by class of issuer (sovereign, agency, supranational, or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to investment guidelines prescribed by the Minister of Finance, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues must have an A-rating or better from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service), one of which must be either Moody's or Standard & Poor's. The Account may also make deposits and execute other transactions with commercial financial institutions that meet the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the Account's assets with the related foreign currency borrowings of the Government of Canada.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to earn extra return on investments.

5. Term Structure of Foreign Currency Investments

	2003						2002
	Par value				Unamortized premium/ discount and accrued interest	Amortized cost	Amortized cost
	Under 6 months	6 to 12 months	1 to 5 years	Over 5 years			
	(millions of US dollars)						
US-dollar holdings							
Government securities	3,200	–	–	–	(5)	3,195	3,114
Other securities	1,375	1,265	5,248	1,504	225	9,617	11,521
Total US-dollar holdings	4,575	1,265	5,248	1,504	220	12,812	14,635
Other foreign currencies							
Euro holdings							
Other securities	521	927	6,539	5,838	501	14,326	13,053
Yen holdings							
Government securities	–	–	465	465	5	935	846
Total other foreign currencies	521	927	7,004	6,303	506	15,261	13,899
Total	**5,096**	**2,192**	**12,252**	**7,807**	**726**	**28,073**	**28,534**

6. Marketable Securities Denominated in US Dollars

	2003			2002		
	Par value	Amortized cost		Par value	Amortized cost	
Securities	US	US	Canadian	US	US	Canadian
			(millions of dollars)			
US government	3,200	3,193	4,141	3,125	3,114	4,913
US federal agencies	5,124	5,182	6,718	4,366	4,415	6,965
Sovereign paper and international institutions	4,268	4,306	5,583	6,875	6,901	10,886
Accrued interest	–	131	169	–	205	324
	12,592	12,812	16,611	14,366	14,635	23,088
Estimated market value at year-end		13,199	17,113		15,316	24,163

Estimated market values are based on quoted market prices.

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. At year-end, a portion of the Account's holdings of US government securities consisting of US$2,250 million (par value) in Treasury Bills (US$2,200 million in 2002) is being used in securities-lending operations with financial institutions.

7. Assets Denominated in Other Foreign Currencies

Cash and short-term deposits

	2003		2002	
	US	Canadian	US	Canadian
		(millions of dollars)		
Euros	13	17	65	102
Japanese yen	76	99	69	109
	89	**116**	**134**	**211**

Marketable securities

	2003			2002		
	Par value	Amortized cost		Par value	Amortized cost	
	US	US	Canadian	US	US	Canadian
			(millions of dollars)			
Euros	13,825	14,326	18,573	12,637	13,053	20,593
Japanese yen	931	935	1,213	842	846	1,335
	14,756	15,261	19,786	13,479	13,899	21,928
Estimated market value at year-end		15,862	20,565		14,597	23,028

Estimated market values are based on quoted market prices.

8. Special Drawing Rights (SDRs)

	2003		2002	
	US	Canadian	US	Canadian
		(millions of dollars)		
Held at year-end	838	1,087	717	1,130
Accrued interest	4	3	2	4
	842	**1,090**	**719**	**1,134**

9. Gold and Gold Loans

During the year, the Account sold 490,067 fine ounces of gold (452,516 fine ounces in 2002).

	2003		2002	
	US	Canadian	US	Canadian
		(millions of dollars)		
Held at year-end				
Gold loans	–	–	23	37
Gold	6	7	5	8
	6	**7**	**28**	**45**

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

	2003		2002	
	Price per fine ounce	Total value in millions	Price per fine ounce	Total value in millions
Carrying value				
US	52.01	6	47.41	28
Canadian	67.43	7	74.79	45
Market value				
US	417.25	45	347.20	208
Canadian	540.96	59	547.74	328

10. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to Can$60 billion by Order-in-Council dated 26 April 2001. At year-end, advances from (deposits with) the CRF consisted of:

	2003	2002
	(millions of Canadian dollars)	
US dollars	23,898	32,852
Canadian dollars	(4,347)	(5,447)
Euros	17,920	20,132
Japanese yen	1,303	1,435
Special drawing rights	(1,175)	(1,304)
	37,599	**47,668**

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

11. commitments

a) Currency Swaps

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility in 2003 or 2002, and there were no commitments outstanding as at 31 December 2003.

b) Gold Options and Forward Contracts

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings. At year-end, the Account had no commitments to sell gold under gold options (20,000 fine ounces in 2002) or forward contracts (US$ 66 million in 2002).

c) Foreign Currency Contracts

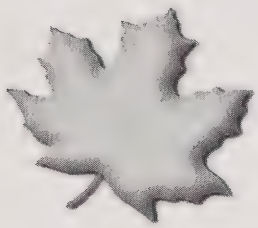
The following table presents the fair value of foreign currency contracts with contractual amounts outstanding at 31 December:

	2003		2002	
	Contractual value	Fair value	Contractual value	Fair value
	(millions of canadian dollars)			
Forward sales	4	–	2,975	(29)
Forward purchases	–	–	2,991	29

The estimated fair values of foreign exchange contracts are calculated using the year-end exchange rates. Foreign exchange contracts that have a positive fair value are those contracts that, if settled immediately, would result in a gain. Conversely, immediate settlement of a contract with a negative fair value would result in a loss.

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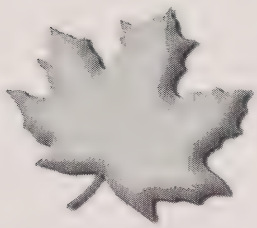
Government
Publications



Report on the Management of Canada's Official International Reserves

2004

Canada



Report on the Management of Canada's Official International Reserves

2004

Department of Finance Canada
Ministère des Finances Canada

Purpose of the Report

The 2004 *Report on the Management of Canada's Official International Reserves* provides a detailed overview of the Government's official international reserves management operations, primarily the operations of the Exchange Fund Account (EFA), for the 2004 calendar year.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets, maintained to provide foreign currency liquidity for the Government of Canada and to provide the funds needed to help promote orderly conditions for the Canadian dollar in foreign exchange markets. The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currency. Assets and liabilities are matched as closely as possible in currency and duration to minimize the Government's exposure to currency and interest rate risks.

The EFA is governed by the provisions of the *Currency Act*, which requires the Minister of Finance to report to Parliament on the operations of the EFA for each calendar year within five months after the end of that year. As such, the report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the year-end position in the EFA portfolio.

Canada's total official international reserves stood at US$34,467 million as of December 31, 2004 (Table 1). The official international reserves consist of the EFA (US$31,030 million), the reserve position in the International Monetary Fund (IMF) (US$3,327 million), and foreign currency accounts held by the Bank of Canada (US$105 million) and the Receiver General (US$5 million).

Table 1

The EFA and Official International Reserves

	2003	2004	Change
	(market value in millions of US dollars, as at December 31)		
Securities[1]	29,111	27,834	-1,277
Deposits	2,315	2,223	-92
Gold	45	48	3
Special drawing rights (SDRs)	838	925	87
Total EFA	32,309	31,030	-1,279
IMF reserve position	3,848	3,327	-521
Bank of Canada account	106	105	-1
Receiver General account	5	5	0
Total official international reserves	36,268	34,467	-1,801

[1] Includes securities issued by sovereigns, agencies and supranationals (international financial organizations).

Highlights of 2004

During 2004 notable developments were:

Change in the level of the official international reserves: As of December 31, 2004, the official international reserves declined to US$34.5 billion from US$36.3 billion as at December 31, 2003. This reflects a US$1.3-billion decrease in EFA assets and a US$0.5-billion decrease in the IMF reserve position.

Change in the level of the EFA: The decline in the EFA from US$32.3 billion to US$31.0 billion was largely due to foreign currency debt maturities, which were met through sales and maturities of assets. The reduction was partly offset by an increase in the value of the EFA, primarily due to the appreciation of the euro against the US dollar.

Funding sources: The program of cross-currency swaps of domestic obligations was the Government's primary source of foreign currency funding. The Government raised US$3.1 billion at an average cost of 3-month US$ LIBOR (London Inter-Bank Offered Rate) less 44 basis points, a slightly more cost-effective funding level than in recent years.

Investment policy: EFA investment policy was reviewed with the aim of assessing the range of assets eligible for investment and ensuring that the Government's policies are in line with leading practices of other comparable sovereign asset managers. As part of this process, the principles and objectives governing the management of the EFA were restated.

Reporting framework: Internal reporting was strengthened with the implementation of a new performance and risk reporting framework. The new framework combines the formerly separate monthly and quarterly investment and risk reports and emphasizes an integrated approach, which improves awareness and understanding of risk/return trade-offs.

Portfolio performance: The EFA is managed on an asset-liability portfolio basis that aims to optimize return and to minimize any cost of carry (interest paid on liabilities less interest earned on assets, plus realized gains) on the portfolio. During 2004, the Government earned net revenues on the EFA of US$91 million, or 25 basis points (27 basis points when the IMF reserve position is included), which reflects US$160 million in realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$69 million (US$64 million when the IMF reserve position is included).

New measure of performance: A new methodology called total return was introduced to measure performance. Total return is a measure based on the market value of both the EFA assets and liabilities and captures three key variables: realized gains/losses on sales of assets, unrealized gains/losses on existing portfolio assets and liabilities, and net interest income. The Government earned a total return of 20 basis points on the EFA portfolio in 2004. When the IMF reserve position is included, the total return increases to 59 basis points.

Annual audit: The Office of the Auditor General conducted its annual audit of the EFA as an investment portfolio. The audited financial statements and a clean audit opinion are included at the end of this report.

Overview of the Exchange Fund Account

This section describes the EFA management framework, including the purpose, objectives and guiding principles; the governance structure of the EFA; and the policies governing investment, asset-liability management, risk management and performance assessment.

Management Framework

Purpose

The purpose of the EFA is to provide a source of funds needed to help promote orderly conditions for the Canadian dollar in the foreign exchange market, and to provide foreign currency liquidity for the Government of Canada.

Key Objectives

Maintain a high standard of liquidity: Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.

Preserve capital value: Minimize risk of loss of market value by holding a diversified portfolio of high-quality assets (in terms of credit rating and type of issuer), managing assets and liabilities on a matched basis (in terms of currency and duration) and using appropriate practices to mitigate risks.

Optimize return: Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

Guiding Principles of Funds Management

Government funds management, which encompasses a wide range of activities related to the issuance of debt and the management of liquid financial assets, including the EFA, follows three general principles:

- *Governance:* The governance framework should ensure that debt and asset management activities are conducted in line with clearly established operational and risk guidelines and that risk monitoring and oversight are independent of treasury management operations.
- *Transparency:* Information on the management and performance should be disclosed in a timely manner so as to ensure public understanding and accountability.
- *Leading practices:* Operational frameworks and practices should be in line with leading practices of other comparable sovereigns. Regular evaluations should be conducted on the effectiveness of the governance framework, policy initiatives and operations.

Additional Reserves Management Principles

- *Prudence:* Borrowing and investment activities should be managed to limit exposure to risk and protect the value of the Government's assets.
- *Cost-effectiveness:* The carrying cost of reserves, taking into account the return on assets and the cost of liabilities, should be kept as low as possible.

Governance of the EFA

The EFA is governed by Part II of the *Currency Act*, which requires the Minister of Finance to report to Parliament on the operations of the EFA each calendar year within five months after the end of that year. The legislative mandate of the EFA is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance can acquire, sell or lend for the Account those assets that are deemed appropriate for the legislated purpose. The Minister of Finance approves the general policies and strategy related to the investment and risk management of the EFA and, in particular, establishes the target level of reserves.

Responsibility for strategic planning and the operational management of the EFA is jointly borne by the Department of Finance Canada and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account.

The oversight of activity is through the Funds Management Committee (FMC), which comprises senior management from the Department of Finance Canada and the Bank of Canada. The FMC advises the Minister of Finance on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcome reports.

The FMC is supported by a Risk Committee (RC), whose mandate is to oversee and advise on the risk management policy and to report to the FMC on financial risk positions and exposures. The Financial Risk Office at the Bank of Canada provides analytical support to the RC in this role and is responsible for monitoring and regularly reporting on the financial performance and position of the EFA, including market, credit, operational, liquidity and legal risks.

EFA Management Policy

Management of the EFA follows a set of policies that apply to investment, asset-liability management, risk management and performance assessment.

Investment Policy

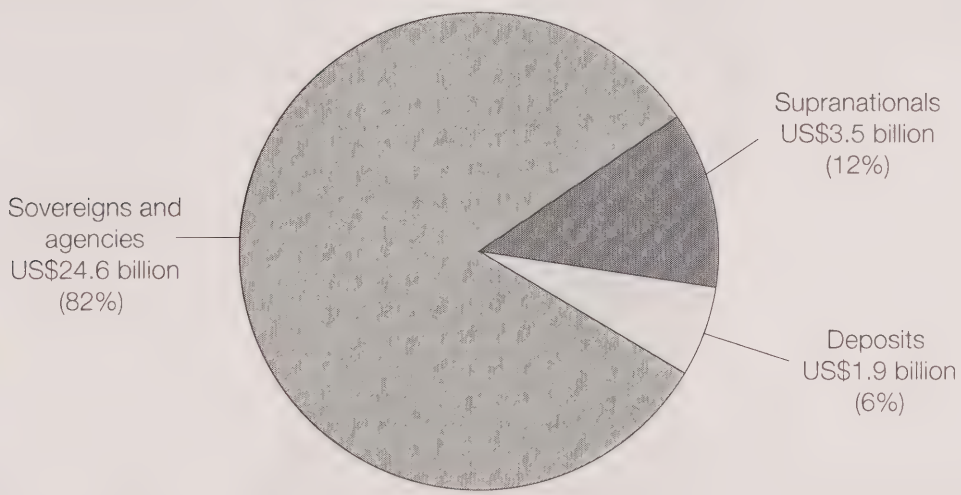
EFA investment policy strives to optimize return, subject to liquidity and capital preservation objectives. To achieve this, the Government's policy is to invest primarily in securities (bonds and bills) issued by sovereigns, agencies or supranationals denominated in US dollars, euro and yen. Reserves can also be invested in cash deposits with financial institutions and in US-dollar tri-party repurchase agreements (repos).

Furthermore, the investment policy splits investments into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the Government's core liquidity requirements in foreign currencies. It consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

To support the investment policy, the investment of reserves is governed by the ministerially approved investment and credit guidelines (see Annex 2), which include limits pertaining to issuers and counterparties across all lines of business and require diversification of assets and counterparties. In addition, high liquidity standards are defined in the guidelines. There are also rules governing the maximum maturity of reserve assets.

In practice, the EFA portfolio is mainly invested in sovereign and agency securities (82 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).[1] This composition has stayed relatively stable over the last five years. The share of deposits is relatively small because money market securities offer lower returns than other investment options. The liquidity tier is composed mainly of US Treasuries, unchanged from previous years, given that they are the most liquid securities in the market.

Chart 1
EFA Investments by Issuer
as at December 31, 2004
(market value)

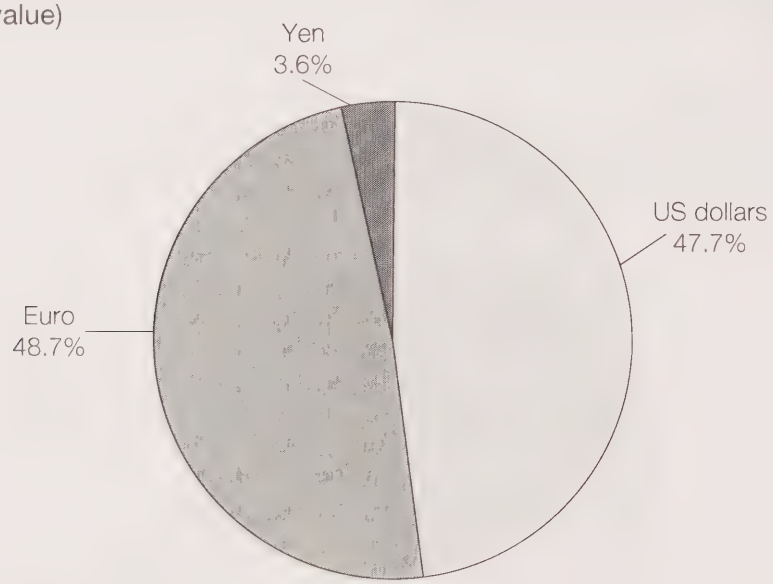


As for the currency mix, the Government's practice is to hold about US$15 billion, subject to an operating range, in US dollars. This reflects the fact that foreign currency needs are mostly in US dollars and that, historically, foreign exchange intervention has taken place primarily in the Canadian/US-dollar exchange market.

[1] Excludes gold and SDR holdings.

As at December 31, 2004, the US-dollar share of the EFA portfolio was US$14.3 billion (or 47.7 per cent), the euro share was 19.8 billion euros (or 48.7 per cent) and the yen portion was 112.1 billion yen (or 3.6 per cent) (Chart 2).[2] The proportion of euro holdings in the EFA portfolio has increased over the years as a result of attractive yield opportunities in the euro market and the appreciation of the euro against the US dollar. This is consistent with the Government's objective of optimizing return while respecting the liquidity and capital preservation objectives.

Chart 2
Currency Composition of the EFA as at December 31, 2004
(market value)



Asset-Liability Management Policy

Policy requires that foreign currency reserve assets and the liabilities financing those assets be managed together on a portfolio basis. Assets and the liabilities financing those assets are matched as closely as possible in currency and duration, so that exposure to significant currency and interest rate risks is limited.

The Government's practice is to minimize the gap between assets and liabilities, which is monitored on a daily basis, within a range of +/-US$300 million.

[2] Excludes gold and SDR holdings.

Risk Management Policy

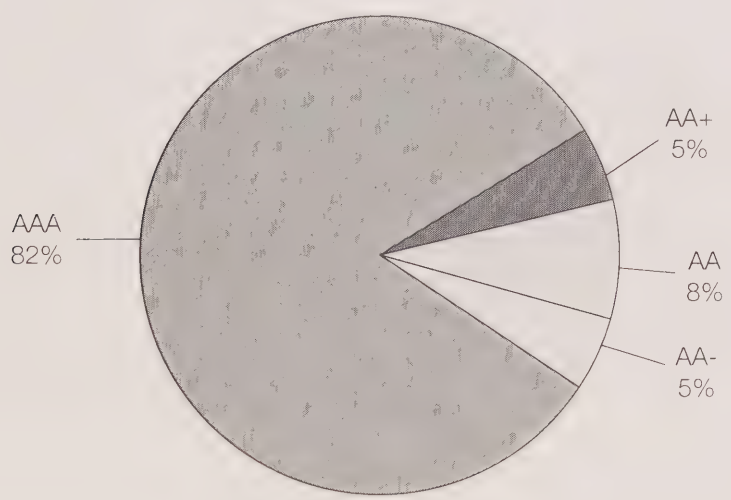
Risk management policy requires identifying and managing treasury risk (including credit, market, operational and legal risks related to the financing and investment of the foreign exchange reserves) and regular and timely reporting of risk exposures.

The Government uses a number of methods to measure financial risk exposures on a timely basis and to ensure compliance with guidelines and specific risk policies. Credit risk is the most important risk faced by the EFA, and it is monitored by measuring actual exposure and potential exposure[3] to counterparties. There is an ongoing assessment of the credit status of the Government's counterparties by relying on third-party credit rating agencies. Counterparty limits are established based on these third-party credit ratings, and compliance with counterparty limits is monitored on a daily basis.

To be eligible for EFA investments, an entity must have a credit rating of at least A-/A3 (see the guidelines in Annex 2 for details). The majority of EFA investments are in the AAA category, as indicated in Chart 3.[4]

The Government also employs measures of market risk exposure that are considered industry standards: stress testing and Value-at-Risk. These measures are described in more detail in the box entitled "New Performance and Risk Measures" in the following section.

Chart 3
EFA Investments by Credit Rating
as at December 31, 2004



[3] Actual exposure is a measure of potential losses to the Government if a counterparty defaults or is downgraded today, while potential exposure is a measure of potential losses in the future.

[4] Excludes gold and SDR holdings.

Collateral management frameworks are used to manage the Government's credit risk to financial institution counterparties associated with cross-currency swaps and commercial deposits. Under these frameworks, high-quality collateral (e.g. cash, securities) is placed with the Government when the market value of the contract exceeds specified limits.

Risk measures are reported on a monthly basis to management at the Department of Finance Canada and the Bank of Canada. The Minister of Finance receives an annual report on treasury risk management prepared in collaboration with the Bank of Canada's Financial Risk Office.

Performance Assessment Policy

Performance assessment policy provides a framework for measuring, analyzing and evaluating financial performance of EFA investing and funding. The policy requires regular and timely reporting to senior management, the Minister and Parliament of the returns on EFA assets and the costs of associated liabilities.

The principal measure is based on accounting information (revenues and the net cost of carry measure), supplemented by an economic measure of asset-liability performance called total return (see the box entitled "New Performance and Risk Measures" in the following section). Performance is reported on a monthly basis to management at the Department of Finance Canada and the Bank of Canada. The Minister is informed every six months of EFA initiatives and performance. Finally, as required by the *Currency Act*, the Office of the Auditor General audits the EFA as an investment portfolio, and performance is reported to Parliament on an annual basis.

Review of Operations in 2004

This section reviews operations related to the official international reserves, including major initiatives undertaken, changes in the level of reserves and portfolio performance. While the report covers all the official international reserves, most of the comments focus on developments affecting the managed element of the reserves, the EFA.

Major Initiatives

In 2004, initiatives focused on strengthening the Government's investment policy and management framework. In addition, extensive work was done to enhance internal reporting through the implementation of a new performance and risk reporting framework.

Review of EFA Investment Principles and Objectives

Over the last decade, the EFA portfolio has grown significantly from US$10 billion in 1995 to US$31 billion in 2004 and, in consequence, investment policy has been subject to periodic revision. In the first half of 2004, investment policy was reviewed with the aim of assessing the range of assets eligible for investment in the EFA portfolio in order to seek a better balance between the low-risk nature of the assets required for the portfolio and the net cost of holding them. A further objective was to ensure that the Government's investment policies are in line with leading practices of other comparable sovereign reserve asset managers. As part of this process, the principles and objectives governing the management of the EFA were restated in order to enhance decision making (see the section entitled "Management Framework").

New Performance and Risk Reporting Framework

During 2004, internal reporting on performance and risks was strengthened through the development and implementation of new performance and risk reports. The new framework combines formerly separate monthly and quarterly investment and risk reports and emphasizes an integrated approach, whereby investment performance and risk exposure information is integrated to give a better sense of the risk/cost trade-offs. Information is also streamlined so as to provide an at-a-glance snapshot of relevant data to senior management, while offering an overall opinion of the financial performance, by drawing on messages in five key areas: investment performance, market risk, credit risk, liquidity risk and operational/legal risk. New performance and risk measures were introduced as part of the new reporting framework (see box below).

New Performance and Risk Measures

New measures to enhance risk and performance reporting were introduced in 2004 based on leading industry standards (see the sections "Total Return" and "Risk Measures" for detailed results).

- Value-at-Risk (VaR) measures potential losses due to normal market movements (i.e. changes in interest rates and exchange rates) over a given period. VaR is calculated for the EFA and for the liabilities financing the EFA.
  - The gross VaR (i.e. applied to the EFA) is relevant as it provides the probability of loss in total reserves due to market movements over a certain time period.
  - The net VaR (i.e. the VaR on the EFA less the VaR on liabilities) is a useful indicator of how well the portfolio is matched. As assets and liabilities are matched in currency and duration, net VaR is expected to be close to nil as changes in foreign exchange and interest rates should impact both assets and liabilities to the same extent.
- Stress tests are used to evaluate portfolio performance under extraordinary circumstances in the market. Under stress testing, the EFA portfolio is subject to a set of hypothetical scenarios that mimic the market conditions that prevailed during four previous extraordinary market events: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management collapse; and the 2001 US terrorist attacks. These hypothetical scenarios allow risk managers to assess how the EFA would perform during periods of market turbulence—the periods in which the EFA would most likely need to be mobilized.
- A "total return" methodology was introduced to accompany existing measures of return. It is based on market values and reflects three key variables: realized gains/losses on sales of assets; unrealized (or valuation) gains/losses on existing portfolio assets and liabilities; and net interest income earned or paid. Return is calculated on the liabilities, as well as the assets, since liabilities fund the assets and assets should match the liabilities in currency and duration. Work will follow in 2005 on the development of a framework for attribution analysis to determine by how much each market variable (i.e. interest rates, exchange rates and credit spreads) impacts total return.

Modernization of the Currency Act

In the second half of 2004, preliminary work was undertaken in preparation for the amendment of the *Currency Act* to enhance the management of the EFA portfolio. The current act sets out a legislated list of approved investments. This approach to investment policy is no longer in keeping with modern legislative drafting practices. The list is very inflexible and excludes instruments that are equivalent to or better in terms of risk and return than some currently eligible assets. As announced in Budget 2005, modernizing the *Currency Act* will improve the flexibility in managing the portfolio by allowing investment in asset classes with lower risk and potentially higher returns. It will also reduce the risk of legal issues arising from antiquated and unclear drafting of some sections of the current legislation.

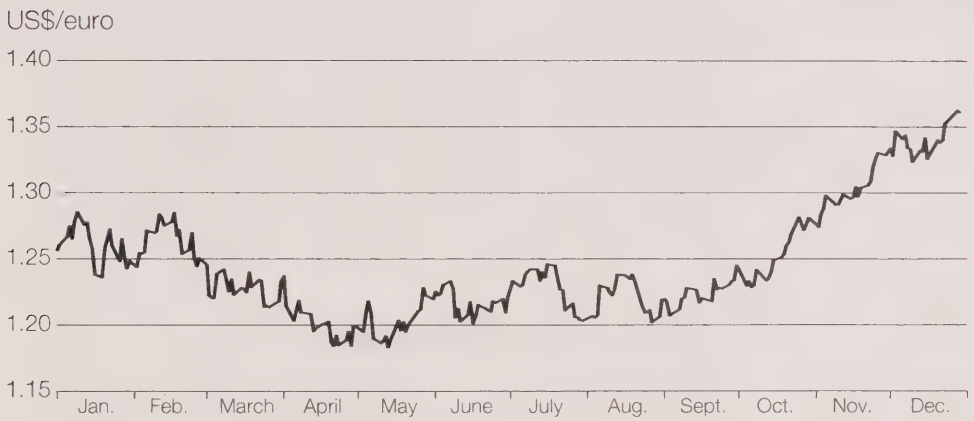
The Market Environment

As the official international reserves are reported on a market-value basis and in US dollars, changes in exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates) and interest rates will affect the level of the reserves.

Developments in Foreign Exchange Markets[5]

As roughly 50 per cent of the official international reserves were held in euro-denominated securities during 2004, the market value of the reserves has been significantly affected by movements in the euro. In 2004, the euro appreciated significantly against the US dollar due to a number of international macroeconomic factors. Overall, the euro appreciated by 7.9 per cent during 2004, reaching a high of 1.3643 (US dollar/euro) on December 30, 2004, while the low for the year was 1.1819 on May 13, 2004 (see Chart 4).

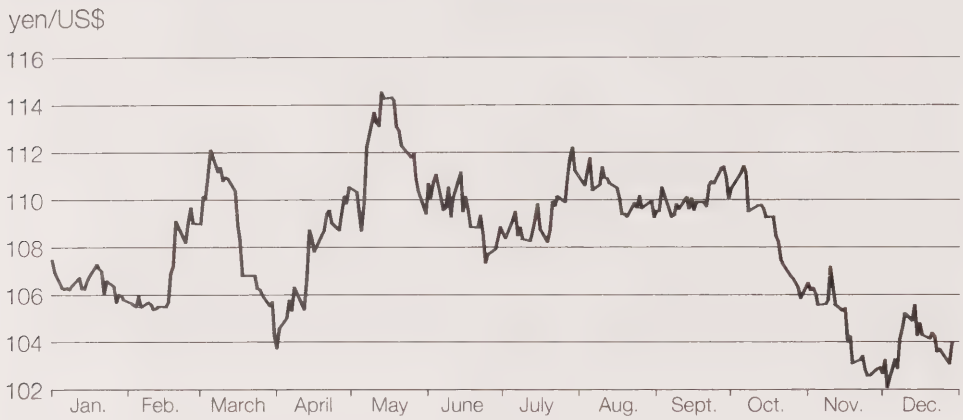
Chart 4
The Evolution of the Euro in 2004



The official international reserves are less subject to changes in the yen/US-dollar exchange rate since only 3.2 per cent of the reserves are held in yen-denominated assets (as at December 31, 2004). Overall, during 2004 the yen appreciated by 4.8 per cent against the US dollar. The high for the year was 102.09 on December 3, 2004, and the low was 114.50 on May 13, 2004 (see Chart 5).

[5] Charts 4 and 5 show the market standard for cross rates, where the euro is quoted in US-dollar terms (i.e. how many US dollars are required to buy 1 euro) and the yen is quoted in yen terms (i.e. how many yen are required to by 1 US dollar). Both charts reflect a decline in the US dollar.

Chart 5
The Evolution of the Yen in 2004



Developments in Interest Rates

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the price of the investments held in the reserves. Movements in interest rates had little impact on the reserves during 2004 compared to movements in exchange rates. The market value of the reserves declined by US$46 million due to changes in interest rates, whereas foreign currency revaluations increased the value of the reserves by US$1.2 billion (see the section entitled "Sources of Changes During 2004").

Composition of the Official International Reserves

Table 2 shows the investments of the four components of the official international reserves by currency and term to maturity. As at December 31, 2004, US-dollar holdings made up more than half of the reserves and were dominated by relatively short- (i.e. under six months) and medium-term (i.e. one to five years) maturities, as they are held for EFA liquidity purposes. The euro holdings, which are held for EFA investment purposes, were more heavily weighted towards medium-term (i.e. one to five years) investments. Likewise, the yen holdings were mostly invested in securities with medium-term maturities.

Table 2

Term Structure of the Official International Reserves as at December 31, 2004

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Bank of Canada account	Receiver General account	Total official international reserves
					(market value in millions of US dollars)					
US-dollar holdings										
Under 6 months	2,107	2,983	2,062	–	–	**7,152**	–	105	5	**7,262**
6 to 12 months	–	–	1,038	–	–	**1,038**	–	–	–	**1,038**
1 to 5 years	–	76	3,176	–	–	**3,252**	–	–	–	**3,252**
Over 5 years	–	1,406	1,477	–	–	**2,883**	–	–	–	**2,883**
Indefinite term[1]	–	–	–	48	925	**973**	3,327	–	–	**4,300**
Total US-dollar holdings	2,107	4,465	7,753	48	925	**15,298**	3,327	105	5	**18,735**
Euro holdings[2]										
Under 6 months	35	241	228	–	–	**503**	–	–	–	**503**
6 to 12 months	–	751	–	–	–	**751**	–	–	–	**751**
1 to 5 years	–	7,625	1,580	–	–	**9,206**	–	–	–	**9,206**
Over 5 years	–	3,789	389	–	–	**4,178**	–	–	–	**4,178**
Total euro holdings	35	12,406	2,197	0	0	**14,638**	0	0	0	**14,638**
Yen holdings[2]										
Under 6 months	81	–	–	–	–	**81**	–	–	–	**81**
6 to 12 months	–	–	–	–	–	**–**	–	–	–	**–**
1 to 5 years	–	1,013	–	–	–	**1,013**	–	–	–	**1,013**
Over 5 years	–	–	–	–	–	**–**	–	–	–	**–**
Total yen holdings	81	1,013	0	0	0	**1,094**	0	0	0	**1,094**
Total	2,223	17,884	9,950	48	925	**31,030**	3,327	105	5	**34,467**

[1] For reporting purposes, gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars.

[2] The respective December 31 exchange rates are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

As shown in Table 3, Canada's official international reserves as at December 31, 2004, were US$34.5 billion (on a market-value basis), down from US$36.3 billion as at December 31, 2003, in large part due to the use of assets to meet large maturities of liabilities occurring in November and December. The sources of changes are detailed in the next section.

Table 3

Canada's Official International Reserves Holdings as at December 31, 2004

		Total official international reserves					
	2003 total official international reserves	EFA	Bank of Canada account	IMF reserve position	Receiver General account	2004 total official international reserves	Change
	(market value in millions of US dollars)						
Securities	**29,111**	27,834	–	–	–	**27,834**	-1,277
Deposits	**2,426**	2,223	105	–	5	**2,333**	-93
Gold	**45**	48	–	–	–	**48**	3
IMF reserve position	**3,848**	–	–	3,327	–	**3,327**	-521
Special drawing rights	**838**	925	–	–	–	**925**	87
Total	**36,268**	31,030	105	3,327	5	**34,467**	-1,801

Sources of Changes During 2004

The level of the official international reserves can change over time due to a variety of factors.

Foreign Exchange Market Intervention

Intervention in the Canadian-dollar foreign exchange market has not occurred since 1998 (see Annex 1). Intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and therefore affects the level of the official international reserves.

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements and for additions to the EFA will affect the official international reserves. There were no net government operations in 2004.

Reserves Management Operations

Debt maturities and purchases of foreign currency assets affect the level of the EFA. Foreign currency assets are purchased with the proceeds of foreign currency issuance (including cross-currency swaps). Large maturities (US$6.0 billion in total, including a US$2.0-billion global bond, three Euro-Medium-Term Note maturities totalling US$1.0 billion, cross-currency swap maturities of US$2.8 billion and a small decline in Canada bills outstanding) contributed the most to the decline in the level of the EFA. These maturities were offset by US$3.1-billion issuance of cross-currency swaps.

Gains and Losses on Gold Sales

This factor reflects the degree to which proceeds from the sales of gold exceed the market value of gold that existed at the end of the previous month. There were no gold transactions in 2004, as the last of the Government's gold bullion was sold in December 2003.

Return on Investments

Return on investments comprises interest earned on investments (US$1.1 billion) and changes in the market value of securities resulting from changes in interest rates (US$46 million). The overall effect on the official international reserves was a net increase of US$1.2 billion.

Foreign Currency Debt-Servicing Costs

Foreign currency debt-servicing costs reduced the level of the official international reserves by US$1.2 billion.

Foreign Currency Revaluations

Revaluation effects reflect changes in the market value of the official international reserves resulting from movements in exchange rates. During 2004, foreign currency revaluations increased the official international reserves by US$1.2 billion, primarily due to the appreciation of the euro versus the US dollar.

As shown in Table 4, the level of the official international reserves fell by US$1.8 billion during 2004. The level decreased due to reserves management operations (US$3.0 billion) and foreign currency debt-servicing costs (US$1.2 billion). The decline was partly offset by return on investments (US$1.2 billion) and foreign currency revaluations (US$1.2 billion), due mainly to the appreciation of the euro versus the US dollar.

Table 4

Sources of Changes in Canada's Official International Reserves During 2004

	Total change in official international reserves
	(market value in millions of US dollars)
Foreign exchange market intervention	–
Net government operations	–
Reserves management operations	-2,963
Gains and losses on gold sales	–
Return on investments	1,176
Foreign currency debt-servicing costs	-1,208
Foreign currency revaluations	1,193
Other transactions[1]	1
Total change	-1,801

[1] Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Annex 3.

Financing

The reserves are financed by foreign currency borrowings by the Government, which are used exclusively to raise foreign exchange reserves (see Table 5). All foreign currency marketable assets are effectively matched to foreign currency borrowings.

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations.[6] Total cross-currency swap issuances and maturities were US$3.1 billion and US$2.8 billion, respectively. Swaps are particularly cost-effective compared to other sources of foreign currency funds. Foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 44 basis points on average, a slightly better funding level than in recent years.

In addition to cross-currency swaps of domestic obligations, the Government has access to a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and Euro Medium-Term Notes—EMTNs) and international bond issues (global bonds), the use of which depends on funding needs and market conditions.

[6] Cross-currency swaps involve the exchange of Canadian dollars, which have been raised through the issuance of domestic bonds, for foreign currency. The foreign currency is subsequently invested in an eligible asset (e.g. US Treasuries).

During 2004, the level of outstanding Canada bills decreased by US$228 million. Canada bills were issued, on average, at an all-in cost of US$ LIBOR less 20-30 basis points—generally in line with funding levels of recent years.

There was no new issuance of Canada notes, EMTNs or global bonds in 2004. One US-dollar global bond (US$2.0 billion) and three EMTNs (totalling US$1.0 billion) matured.

While the changes in the numbers shown below may reflect maturities, they also reflect changes in the exchange rates of the euro and the yen versus the US dollar (as the foreign currency issues in Table 5 are reported in US dollars).

Table 5

Foreign Currency Issues as at December 31, 2004

	2003	2004	Change
		(par value[1] in millions of US dollars)	
Global bonds	9,896	8,131	-1,765
Canada bills	1,652	1,424	-228
Swapped domestic issues	18,456	19,378	922
Canada notes	931	976	45
Euro Medium-Term Notes	2,413	1,434	-979
Total	33,348	31,343	-2,005

[1] Liabilities are stated at the respective years' December 31 exchange rates.

Portfolio Performance

Revenues

The revenues of the official international reserves include income from its investments and foreign exchange gains. In 2004, the income of the official international reserves totalled C$1.8 billion, compared to almost C$3.0 billion in 2003.

The main categories of income earned by the official international reserves are summarized in Table 6. Data is reported in Canadian dollars, as EFA revenues, which account for the bulk of the revenues of the official international reserves, are reported in Canadian dollars in the attached financial statements.

The EFA's securities-lending program enhances the income earned on the portfolio by lending out securities that are highly sought after in the market. At year-end, C$3.6 billion[7] (par value) in US government securities were held by the two financial institutions that act as agents for lending these securities to market participants. Income from securities lending, included in investment income from marketable securities in Table 6, totalled C$2.6 million during 2004 compared to C$1.3 million in 2003.

[7] Securities-lending numbers are stated at the respective years' December 31 exchange rates.

Table 6

Revenues for the Official International Reserves as at December 31, 2004

		Official international reserves				
	2003 total revenue	EFA	IMF reserve position	Bank of Canada account	Receiver General account[1]	2004 total revenue
	(millions of Canadian dollars)					
Investment income						
Marketable securities	**1,931**	1,588	–	–	–	**1,588**
Cash and short-term deposits	**49**	35	–	2	0	**2**
Special drawing rights	**21**	21	–	–	–	**21**
IMF reserve position	**–**	–	–	–	–	**–**
Total investment income	**2,001**	1,644	–	2	0	**1,646**
Other income						
Net gain on sales of gold	**205**	–	–	–	–	**–**
Foreign exchange gains (losses)	**757**	154	–	–	0	**154**
Total income	**2,963**	1,798	–	2	0	**1,800**

[1] Zero values in this column indicate that the values reported were less than C$500,000.

Net Return

As the EFA is managed on an integrated asset-liability basis, from an economic perspective, the key measures of portfolio performance should include both assets and liabilities. Historically, the net performance, incorporating the cost of funding, has been measured and reported using the cost of carry methodology. The cost of carry is an accounting-based measure estimated by subtracting the interest earned on assets from the interest paid on Canada's foreign currency liabilities (i.e. the net interest earned or paid). Last year, the measure was improved by adding realized gains/losses incurred over the year.

The new measure, total return, is calculated for both the assets and the liabilities and for each currency, with the return on the liability portfolio being used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). Work is continuing on improving both the cost of carry measure and the total return methodology. Performance according to both measures is presented below.

Cost of Carry

Table 7 provides an estimate of the cost of carry for the official international reserves[8] and for segments of the reserves. The cost of carry during 2004 is estimated at -19 basis points, which is lower than in 2003. The carry would have

[8] The cost of carry calculations do not apply to the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

been better had the Government not sold older, higher-coupon assets for newer issues with a lower coupon; therefore it earned less interest over the year. However, interest earnings were supplemented by market-value gains accumulated over several years on the high-coupon securities sold in 2004. When the realized gains are taken into consideration, the overall carry is estimated at +27 basis points. The cost of carry performance, including realized gains, was also lower than in 2003. The net cost of carry declined primarily due to higher US yields in 2004, which in turn caused a decrease in asset prices and lowered market values of US securities.

Table 7

Carry for the Official International Reserves During 2004

	2003		2004				
	Carry in basis points (bps)	Carry in bps (including net realized gains)	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry in bps[1]	Carry in bps (including net realized gains)
			(millions of US dollars)				
Euro portfolio	2	45	586.9	610.9	-24.0	-7.2	19.7
Yen portfolio	0	0	11.7	11.8	0.1	–	–
US$ portfolio	-12	47	508.9	554.0	-45.1	-13.4	5.3
EFA[2]	**-10**	**92**	**1,107.5**	**1,176.7**	**-69.2**	**-20.6**	**25.0**
IMF reserve position	4	4	47.2	42.1	5.1	1.5	1.5
Total carry	**-6**	**96**	**1,154.7**	**1,218.8**	**-64.1**	**-19.1**	**26.5**

[1] The carry figures show the contribution of each currency portfolio to the overall carry.

[2] Excludes gold holdings.

Total Return

Table 8 provides an estimate of the total return for the official international reserves[9] as a whole and for segments of the reserves. The total return was +59 basis points in 2004, reflecting total returns of +20 basis points for the EFA and +409 basis points for the IMF reserve position. These numbers include interest flows as well as all realized and unrealized gains/losses. As total return is a new measure, no comparison for 2003 is available.

Two general factors contributed to the strong investment performance of the EFA in 2004: advantageous funding levels for cross-currency swaps, which were the main tool used to raise foreign currency, and an appreciation in the value of assets relative to the liabilities that fund these assets.

[9] The total return calculations do not apply to gold, SDR holdings and the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

The +409-basis-point net return on the SDR-denominated IMF reserve position was largely driven by an appreciation of the SDR against the US dollar, which drove up the return on the assets from 1.50 per cent in SDR to 5.75 per cent in US dollars (the IMF reserve position is financed by US-dollar-denominated liabilities).

Table 8

Total Return for the Official International Reserves During 2004

	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA	IMF reserve position	Total official international reserves[1]
	(millions of US dollars, unless otherwise stated)					
Market value	14,324	14,637	1,094	**30,055**	3,064	**33,119**
Change over the period	-1,152	-265	46	**-1,371**	-472	**-1,844**
% of the portfolio	43%	44%	3%	**91%**	9.3%	**100%**
Return in original currency	1.95%	5.56%	0.74%	**n/a**	1.50%	**n/a**
Return in US$ (A)	1.95%	13.90%	5.59%	**7.74%**	5.75%	**7.53%**
Liability benchmarks						
Market value	14,205	14,458	1,090	**29,753**	3,064	**32,816**
Change over the period	-1,427	-210	47	**-1,591**	-308	**-1,898**
Return in original currency	1.64%	5.47%	0.75%	**n/a**	1.64%	**n/a**
Return in US$ (B)	1.64%	13.80%	5.61%	**7.54%**	1.64%	**6.94%**
Return vs. benchmark in basis points (A – B)	31	10	-1	**20**	409	**59**[2]

[1] The total return calculations do not apply to gold, SDR holdings and the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

[2] The returns of the three currency portfolios and the IMF reserve position show their weighted contributions to the overall total return.

Risk Measures

Various methods, including scenario analysis, stress testing as well as Value-at-Risk (VaR), a statistical measure of risk exposure, are employed to measure the EFA's exposure to market risk.[10] Scenario analysis is also carried out to gauge the sensitivity of the EFA portfolio to changes in exchange rates and interest rates. As part of the scenario analysis, the results of the portfolio impact of a 1-per-cent depreciation of the euro and yen vis-à-vis the US dollar, and those of a 1-per-cent increase in interest rates across the yield curve, are also reported. The results show that, on a net basis, the EFA portfolio has very minimal exposure to currency depreciations and upward shifts in the yield curve (Table 9).

[10] These risk measures apply to the EFA only, excluding the SDR and gold holdings.

Table 9

Risk Measures as at December 31, 2004

Risk measure	EFA	Net EFA (EFA assets less liabilities)
	(millions of US dollars)	
Scenario analysis		
1% depreciation of euro/yen	-157	-2
1% parallel shift in yield curve	-797	-5
Stress test		
1994 Fed tightening	-2,345	12
1997 Asian financial crisis	-814	48
1998 Russian default/LTCM collapse	-1,149	68
2001 terrorist attacks	993	38
99% 10-day VaR	1,103	18

Stress testing is a risk management tool that is used to assess the potential impact on the EFA portfolio of extreme market turbulence. To this end, the EFA portfolio is subjected to some hypothetical scenarios that mimic the market conditions during four previous extraordinary market events: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The four stress tests reveal that the EFA generally performs well during periods of market turmoil.

In addition, this report includes a new measure of market risk exposure, the VaR, as a complement to scenario analysis and stress testing. This measure estimates the maximum loss in portfolio value expected within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is reported on the entire EFA portfolio and on the net position between assets and liabilities. As of December 31, 2004, the EFA had a 99-per-cent 10-day VaR of $18 million, which implies that 99 per cent of the time, the value of the portfolio is not expected to decline by more than $18 million, on a net basis, over a 10-day period.

Currently, a measure of credit VaR is being developed for estimating the maximum expected losses over a specified time period as a result of a credit event, such as a counterparty downgrade or default.

Annex 1: Foreign Exchange Market Intervention

Since September 1998, the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[11] Since that time, its only market intervention was the purchase of euros in 2000 as part of Canada's participation in the Group of Seven concerted intervention in support of the euro, as shown in Table 10.

Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy; the goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Table 10

Foreign Exchange Market Intervention

	2000	2001	2002	2003	2004
	(millions of US dollars)				
Purchases	97	–	–	–	–
Sales	–	–	–	–	–
Net	97	–	–	–	–

[11] Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

Annex 2: Investment and Credit Guidelines for the EFA

I. Eligible Issuers

To be eligible for EFA investments, an entity must have a credit rating in the top seven long-term categories from at least two of the following four rating agencies, at least one of which must be either Moody's Investors Service or Standard & Poor's:

Ratings agency	Minimum rating
Moody's Investors Service	A3 or better
Standard & Poor's	A- or better
Fitch Ratings	A- or better
Dominion Bond Rating Service	A (low) or better

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

II. Aggregate and Individual Limits on Holdings

a) Sovereigns and Directly Guaranteed Agencies

Type of issuer	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies)	25	10
AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
Single-A sovereigns (including directly guaranteed agencies)	2	See below[1]

[1] *The limits for single-A sovereigns (including directly guaranteed agencies) are as follows:*

Credit rating	Total exposure	Of which home currency	Of which non-home currency
	(millions of US dollars)		
A+	500	500	50
A	250	250	25
A-	100	100	10

b) Other Eligible Securities/Deposits

Type of issuer/ financial institution	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
Implicitly guaranteed sovereign agencies (including eligible US agencies)	15	3
Supranationals (not including deposits at the BIS)	25	10
Deposits at the BIS	10	–
Commercial bank deposits	US$1.5 billion	See limits below

III. Financial Institution (FI) Counterparty Credit Risk Limits

a) For Swaps, Deposits and Forwards

	Credit rating of FI counterparty						
Type of exposure	A-	A	A+	AA-	AA	AA+	AAA
	(millions of US dollars)						
Actual exposure	10	25	50	100	150	200	300
Aggregate actual exposure for all FI counterparties	2% of liquid reserves			n/a	n/a	n/a	n/a
	25% of liquid reserves						
Potential exposure[1]	10	25	50	200	200	200	200
Total potential exposure for all FI counterparties	1,250						

[1] Potential exposure on swaps and forwards is calculated based on BIS guidelines.

b) For Repo Transactions

Minimum credit rating for a counterparty	A-	
Business line limits for counterparties, by credit rating	AAA	US$750 million
	AA	US$500 million
	A	US$300 million
Eligible collateral	US Treasuries and agencies	
Minimum rating for collateral	AAA	
Maximum term of collateral	10.5 years	

IV. Terms of Investments

Instrument	Maximum term
Commercial bank deposits and other non-marketable investments	3 months
Commercial bank marketable investments	1 year
All other marketable securities	10.5 years (unless matching a specific liability that exceeds 10.5 years)

V. Liquidity Limits

Minimum holdings of US Treasuries	10% of liquid reserves
Minimum issue size	US$500 million
Maximum holding of any issue/note program/commercial paper (CP) program	10% of the issue/note program/CP program
Maximum non-marketable investments beyond 5 days in term	15% of liquid reserves

VI. Currency Composition Guideline

Currency	Portion of liquid reserves
US dollar	US$15 billion, subject to an operating range
Euro and/or yen	Remainder of the EFA

Annex 2: Canada's Official International Reserves

Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change	Reserves management operations[4]	Gains and losses on gold sales	Return on investments[5]	Foreign currency debt charges	Revaluation effects	Net government operations[6]	Official intervention	Other transactions[7]
							(market value in millions of US dollars)								
2003															
December	29,421	2,116	45	838	3,848	36,268	-901	-3,673	-8	862	-1,299	3,043	-60	0	234
2004															
January	29,488	2,163	44	835	3,836	36,366	98	109	0	134	-41	-104	0	0	0
February	29,683	1,805	43	847	3,705	36,083	-283	-506	0	251	-24	-4	0	0	0
March	30,043	1,874	46	847	3,602	36,412	329	444	0	167	-120	-162	0	0	0
April	29,039	1,785	42	832	3,415	35,113	-1,299	-461	0	-235	-65	-538	0	0	0
May	28,867	2,806	43	851	3,411	35,978	865	670	0	-69	-32	296	0	0	0
June	28,957	2,234	43	849	3,335	35,418	-560	-355	0	65	-275	5	0	0	0
July	29,194	1,852	43	845	3,267	35,281	-217	26	0	153	-164	-232	0	0	0
August	29,517	2,128	44	857	3,345	35,891	690	256	0	269	-24	194	0	0	-5
September	30,057	2,103	45	862	3,198	36,265	374	106	0	43	-86	306	0	0	5
October	30,327	1,945	46	880	3,262	36,460	195	-371	0	181	-126	511	0	0	0
November	27,887	1,889	49	912	3,334	34,071	-2,389	-2,984	0	44	-111	662	0	0	0
December[8]	28,151	2,016	48	925	3,327	34,467	396	103	0	173	-140	259	0	0	1
Total	n/a	n/a	n/a	n/a	n/a	n/a	-1,801	-2,963	0	1,176	-1,208	1,193	0	0	1

1 Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

2 Special drawing right (SDR)-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

3 The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

4 Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

5 Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

6 Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

7 Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

8 Numbers are from the official international reserves press release. Securities and deposits numbers may not be consistent with numbers throughout the text due to a difference in classification.

Annex 4: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through Chase Manhattan Bank in New York City. Primary distribution occurs through five dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present, the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

Euro Medium-Term Note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley Dean Witter. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

repo; repurchase agreement: Transaction in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. This transaction is similar to a secured loan, where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

special drawing right (SDR): An SDR is an international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

Exchange Fund Account

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and for related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

D. A. Dodge
Governor
Bank of Canada

Ian E. Bennett
Deputy Minister
Department of Finance

S. Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
March 11, 2005

Auditor's Report

To the Minister of Finance

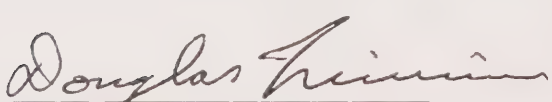
I have audited the balance sheet of the Exchange Fund Account as at December 31, 2004 and the statement of revenue for the year then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2004 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.



Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 11, 2005

Exchange Fund Account

Balance Sheet as at 31 December 2004

	2004	2003
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 4)	2,668	3,065
Marketable securities (note 5)	31,761	35,707
	34,429	38,772
Other assets		
Special drawing rights	1,107	1,087
Gold	7	7
Accrued interest and other receivables (note 6)	637	696
	1,751	1,790
	36,180	40,562
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 7)	34,382	37,599
Net revenue for the year	1,798	2,963
	36,180	40,562

Approved:

D. A. Dodge
Governor
Bank of Canada

Ian E. Bennett
Deputy Minister
Department of Finance

S. Vokey, CA
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Revenue
For the Year Ended 31 December 2004

	2004	2003
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,588	1,931
Cash and short-term deposits	35	49
Special drawing rights	21	21
	1,644	2,001
Other revenue		
Net gain on sales of gold	–	205
Net gain on foreign exchange	154	757
	154	962
Net revenue for the year	1,798	2,963

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to the Financial Statements
Year Ended 31 December 2004

(Amounts in the notes to the financial statements are in millions of Canadian dollars, unless otherwise stated.)

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Account are to provide general liquidity for the government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances.

The net revenue for the year is payable to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in accordance with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances. The advances are provided interest free under the terms and conditions prescribed by the Governor in Council and the Account reflects only transactions pertaining to the assets of the Account. The significant accounting policies of the Account are set out below.

a) Basis of Presentation

The purpose of the financial statements is to report to Parliament on the operations of the Account to comply with the *Currency Act*. The Bank of Canada, on behalf of the Minister of Finance, may sell, lend, borrow, or deal in assets under

the terms and conditions prescribed by the *Currency Act*. The reporting entity of the Account is limited to those transactions permitted by the *Currency Act*. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada. These costs are not recognized in the financial statements.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Governor in Council.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

All material changes in cash flows are evident from the financial statements. A separate statement of cash flows has not been prepared.

b) Use of Estimates

The preparation of the financial statements of the Account requires management to make estimates and assumptions, based on information available as of the date of the financial statements. The most significant use of estimates is in the presentation of assets at fair value. Actual results could differ from those estimates.

c) Translation of Foreign Currencies and Special Drawing Rights

Assets and advances denominated in foreign currencies and special drawing rights (SDRs) are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates, which were as follows:

	2004	2003
US dollars	1.2020	1.2965
Euros	1.6287	1.6282
Japanese yen	0.011727	0.01207
SDRs	1.86050	1.92656

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year, are recorded as net foreign exchange gains and are included separately in the category *Other revenue* in the *Statement of Revenue*.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

d) Revenue

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Interest is accrued on short-term deposits, marketable securities, and special drawing rights. Accrued interest is recorded in the category *Other assets* on the *Balance sheet*.

e) Assets

Short-Term Deposits
Short-term deposits are money market transactions where the Account invests funds with designated counterparties. Short-term deposits are recorded at cost and are generally held to maturity.

Marketable Securities
Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums. Purchases and sales of securities are recorded at the settlement dates. Write-downs to reflect other than temporary impairment in the fair value of securities are included in *Revenue from investments*.

Special Drawing Rights
The special drawing rights (SDR) serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. SDRs are recorded at year-end market value.

Gold
Gold is carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*. The Account sold its remaining gold bullion in 2003 and continues to hold gold coins. Net gains on gold sales are recorded at settlement dates.

f) Tri-Party Reverse Repurchase Agreement

Tri-party reverse repurchase agreements are money market transactions where the Account invests funds on a secured basis with designated counterparties at prevailing market rates. The collateral on these transactions is held by a tri-party custodian. Tri-party reverse repurchase transactions are recorded on the *Balance sheet* under the category *Cash and short-term deposits* at the amount originally invested. Revenue from these transactions is included in the category *Revenue from investments* in the *Statement of Revenue*.

g) Securities Lending Program

The Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents who guarantee the loans and obtain collateral of equal or greater value from their approved

counterparties in these transactions. The securities loaned continue to be accounted for as investment assets. Revenue from the securities-lending program is included in *Revenue from investments* in the *Statement of Revenue*.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar or to meet net government requirements for foreign exchange. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 90 per cent (89 per cent in 2003) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

4. Cash and Short-Term Deposits

Cash and short-term deposits are held as follows:

	2004	2003
	Carrying value	Carrying value
US dollar holdings	2,529	2,950
Euro holdings	42	16
Japanese yen holdings	97	99
	2,668	3,065

5. Marketable Securities

Marketable securities are held as follows:

Term to maturity

	2004									2003
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Carrying value
US dollar holdings										
Sovereign	3,979	2.31%	181	6.85%	308	3.81%	1,889	4.33%	6,357	5,812
Supra National	981	5.46%	363	4.33%	1,244	4.15%	121	4.46%	2,709	3,912
Agencies and other	1,042	4.33%	677	3.45%	2,229	4.25%	1,337	4.83%	5,285	6,718
Carrying value	6,002		1,221		3,781		3,347		14,351	16,442
Euro holdings										
Sovereign	286	2.89%	719	3.64%	7,281	4.23%	3,357	4.95%	11,643	12,330
Supra National	–		–		660	4.54%	329	4.73%	989	1,169
Agencies and other	264	4.27%	163	3.41%	2,390	4.39%	788	4.85%	3,605	4,558
Carrying value	550		882		10,331		4,474		16,237	18,057
Yen holdings										
Sovereign	–		–		1,173	1.24%	–		1,173	1,208
Carrying value	–		–		1,173		–		1,173	1,208
Total securities										
Carrying value	6,552		2,103		15,285		7,821		31,761	35,707

The yield in the above table represents the weighted average yield to maturity based on the carrying value at the end of the year for the respective securities.

The outstanding unamortized premium/discount on marketable securities amounts to $230 million ($251 million in 2003).

At year-end, a portion of the Account's holdings of US government securities, consisting of US$1,830 million (par value) in Treasury Bills (US$2,550 million in 2003) and US$1,165 million (par value) in Treasury Notes (nil in 2003), is being used in securities-lending operations with financial institutions.

6. Accrued Interest and Other Receivables

	2004	2003
Accrued interest		
Cash and short-term deposits	4	2
Marketable securities		
US dollar holdings	164	169
Euro holdings	461	516
Japanese yen holdings	4	5
SDRs	4	3
Other receivables	–	1
	637	696

The fair value of the accrued interest and other receivables is deemed equal to their carrying value given their maturity date.

7. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to $60 billion by Order-in-Council dated 26 April 2001. At year-end, advances from (deposits with) the CRF consisted of:

	2004	2003
US dollars	20,332	23,898
Canadian dollars	(2,108)	(4,347)
Euros	16,027	17,920
Japanese yen	1,266	1,303
SDR	(1,135)	(1,175)
	34,382	37,599

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

8. Financial Instruments

a) Risk Management

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the Account asset portfolio is prudently diversified with respect to credit risk, the investment guidelines prescribed by the Minister of Finance specify limits on holdings by class of issuer (sovereign, agency, supranational, or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to investment guidelines, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues must have a minimum long-term rating of A- or A3 from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service), one of which must be either Moody's or Standard & Poor's. The Account may also make deposits and execute other transactions with commercial financial institutions that meet the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to earn extra return on investments.

b) Interest Rate and Foreign Currency Risk

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the Account's assets with the related foreign currency borrowings of the Government of Canada.

c) Fair Value of Financial Instruments

	2004		2003	
	Carrying value and accrued interest	Fair value	Carrying value and accrued interest	Fair value
Investments				
Cash and short-term deposits	2,672	2,672	3,067	3,067
Marketable securities				
US dollar holdings	14,514	14,685	16,611	17,113
Euro holdings	16,698	17,552	18,573	19,306
Japanese yen holdings	1,178	1,218	1,213	1,259
	35,062	36,127	39,464	40,745
SDRs	1,111	1,111	1,090	1,090
Gold	7	57	7	59

The estimated fair value of cash, short-term deposits, and SDRs is deemed equal to their carrying value given their maturity date.

Estimated fair values of marketable securities are based on quoted market prices.

The estimated fair value of gold is based on London fixings of $526.48 ($540.96 in 2003) per fine ounce.

9. Commitments

a) Currency Swaps

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility in 2004 or 2003, and there were no commitments outstanding as at 31 December 2004.

b) Foreign Currency Contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 December 2004, the Account was under contract to sell $8 thousand ($4 million in 2003) of foreign currency. Unrealized gains (losses) are calculated using the year-end exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil in 2003).

10. Comparative Figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.

Government
Publications

Report on the Management of Canada's Official International Reserves

January 1, 2005 – March 31, 2006



CANADA'S NEW GOVERNMENT

TURNING A NEW LEAF

Canada

Report on the Management of Canada's Official International Reserves

January 1, 2005 – March 31, 2006

Department of Finance Canada
Ministère des Finances Canada



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The legal framework governing the Exchange Fund Account, the *Currency Act*, was amended in 2005 to enhance the management of the official international reserves. As part of the amendments, the law was changed to stipulate that this report be published on a fiscal-year basis, consistent with the period covered by the *Public Accounts of Canada*. In previous years the report was produced on a calendar-year basis, with the previous report covering the year ending December 31, 2004. The current report contains information spanning the 15-month period beginning January 1, 2005 and ending March 31, 2006.

Purpose of the Report

This edition of the *Report on the Management of Canada's Official International Reserves* provides details on official international reserves operations, primarily the management of the Exchange Fund Account (EFA), from January 1, 2005 to March 31, 2006.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets, maintained to provide foreign currency liquidity for the Government of Canada and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in foreign exchange markets. The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currency. Assets and liabilities are matched as closely as possible in currency and duration to minimize exposure to currency and interest rate risks.

The report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the fiscal year-end position of the EFA asset portfolio.

On a market-value basis, the official international reserves stood at US$36,034 million as of March 31, 2006 (Table 1), including the International Monetary Fund (IMF) reserve position, which is Canada's investment in the activities of the IMF and an asset in the official international reserves. The IMF reserve position, which is not actively managed, fluctuates according to requests and repayments from the IMF.

Table 1

The EFA and Official International Reserves

	December 31, 2004	March 31, 2006	Change
	(market value in millions of US dollars)		
Securities	27,834	28,420	586
Deposits	2,223	5,596	3,373
Gold	48	63	15
Special drawing rights (SDRs)	925	917	-8
Total EFA	31,030	34,996	3,966
IMF reserve position	3,327	1,038	-2,289
Bank of Canada account[1]	105	–	-105
Receiver General account[1]	5	–	-5
Total official international reserves	34,467	36,034	1,567

[1] In 2005–06, the definition of official international reserves was revised to be consistent with IMF guidelines. As a result, the Bank of Canada and Receiver General accounts are no longer included in the definition of official international reserves.

Highlights

Changes in the Legislative Framework

- Amendments to Part II of the *Currency Act* were introduced and passed in 2005, as part of the *Budget Implementation Act, 2005*. The *Currency Act* was amended to improve the flexibility in managing the EFA. The amended act provides the Minister of Finance with the authority to set investment policy, and requires that an annual report be made to Parliament on the management of the EFA. To fulfill the revised statutory obligations, a *Statement of Investment Policy* was approved by the Minister in December 2005 (with amendments effective as of September 2006), setting out the policies that govern the acquisition, management and divestiture of EFA assets (see Annex 1).

Portfolio Management

- *Change in the level of the official international reserves:* The market value of the official international reserves increased to US$36.0 billion as of March 31, 2006 from US$34.5 billion as of December 31, 2004. The change included a US$4.0-billion increase in EFA assets, a US$2.3-billion decrease in the IMF reserve position, and the removal of unrelated Bank of Canada and Receiver General accounts, totalling US$0.1 billion, from the reserves portfolio.
- *EFA funding sources:* The program of cross-currency swaps[1] of domestic obligations was the primary source of foreign currency funding for the EFA. US$8.0 billion was raised at an average cost of 3-month US$ LIBOR (London Inter-Bank Offered Rate) less 35 basis points, a funding cost comparable to previous years.

Performance and Risk Measurement

- *Asset-liability portfolio performance:* The EFA is a stand-alone asset portfolio within the Public Accounts framework and is audited on this basis. However, it is managed against a portfolio of Government of Canada foreign currency liabilities in order to provide transparency on its net return to the Government and to minimize risk. From January 1, 2005 to March 31, 2006, the Government earned net revenues of US$75 million, or 25 basis points, which includes US$227 million in net realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$152 million. In terms of total return expressed on a yield basis (including net interest income and all gains or losses earned over the period, regardless of whether they were realized or not), the net total return was US$44 million, or 17 basis points.

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[1] Cross-currency swaps involve the exchange of Canadian dollars, which have been raised through the issuance of domestic bonds, for foreign currency. The foreign currency is subsequently invested in an eligible asset (e.g. US Treasuries).

Enhanced performance and risk measurements: External asset indices[2] were introduced in 2005 in order to enhance the understanding of the performance of the EFA in relation to broader market developments. The EFA asset portfolio performed in line with the broad index used for comparison purposes during the reporting period. New credit risk measures were also introduced, including a credit Value-at-Risk model and credit risk stress tests, providing better information on risks.

Portfolio risk: Market risk measures (Value-at-Risk and various stress tests) indicate that the EFA portfolio was at all times well positioned to cope with movements in interest rates and exchange rates, and that it would perform well during periods of market turbulence. Similarly, various credit risk measures show that the EFA portfolio was continuously well positioned in terms of its credit risk exposure.

2 External asset indices are based on Merrill Lynch composite indices.

Overview of the Exchange Fund Account Management Framework

This section describes the EFA management framework, including the purpose, objectives and guiding principles; governance structure; and the policies governing investment, asset-liability management, risk management and performance measurement.

Objectives and Principles

Purpose

The purpose of the EFA is to provide foreign currency liquidity and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in foreign exchange markets.

Strategic Objectives[3]

- *Maintain a high standard of liquidity:* Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- *Preserve capital value:* Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis (in terms of currency and duration), and using appropriate practices to mitigate risks.
- *Optimize return:* Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

Overarching Funds Management Principles

- *Risk management:* Debt and asset management activities should be conducted in line with clear operational and risk guidelines, and risk monitoring and oversight should be independent of treasury management operations.
- *Efficiency and effectiveness:* Policy and operational standards should take into account, to the extent possible, leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework, policy initiatives and operations.
- *Reporting:* Information on funds management plans, activities and outcomes should be made publicly available in a timely manner so as to ensure understanding and accountability.

Reserves Management Principles

- *Prudence:* The foreign reserves should be managed to limit exposure to financial risk through the matching of assets and liabilities, prudent investment limits and diversification in instruments and currencies held.
- *Cost-effectiveness:* The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.

[3] Section 21(2)(c) of the *Currency Act* stipulates that this report include the objectives of the EFA for the reporting period and the current fiscal year. The strategic objectives in the current fiscal year (2006–07) are unchanged from 2005–06.

Governance of the EFA

The Currency Act

Through the *Budget Implementation Act, 2005*, the *Currency Act* was amended to enhance the management of the EFA portfolio. The amended act improves the flexibility in managing the EFA by allowing investment in asset classes with potentially better risk-return profiles. It also reduces the risk of legal issues arising from antiquated and unclear drafting of some sections of the previous legislation. The amended act, which came into effect on December 30, 2005, allows the Minister of Finance to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy*.

Statement of Investment Policy

A *Statement of Investment Policy* (SIP) was approved by the Minister in December 2005. The SIP sets out the policy governing the acquisition, management and divestiture of assets for the EFA and details the investment objectives, eligible asset classes and currencies, and risk exposure limits. The policies are designed to ensure prudent and effective management practices are followed in accordance with reserves management objectives and principles. The latest SIP, including amendments effective as of September 2006, is provided in Annex 1.

Governance Structure

Responsibility for the management of assets in accordance with the SIP, including strategic planning and the operational management of the EFA, is shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account.

The oversight of activity is through a Funds Management Committee (FMC), comprised of senior management from the Department of Finance and the Bank of Canada. The Committee advises the Minister on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcome reports.

The FMC is supported by a Risk Committee, whose mandate is to oversee and advise on the risk management policy and to report to the FMC on financial risk positions and exposures. The Financial Risk Office at the Bank of Canada provides analytical support to the Risk Committee in this role and is responsible for monitoring and regularly reporting on the EFA's financial performance and its exposure to credit, liquidity, market and operational risks.

For more information on the governance framework of the EFA, please consult the document entitled *Treasury Management Governance Framework* at www.fin.gc.ca/treas/Goveev/TMGF_e.html.

EFA Management Policy

Management of the EFA follows a set of policies that apply to investment, asset-liability management, risk management and performance measurement.

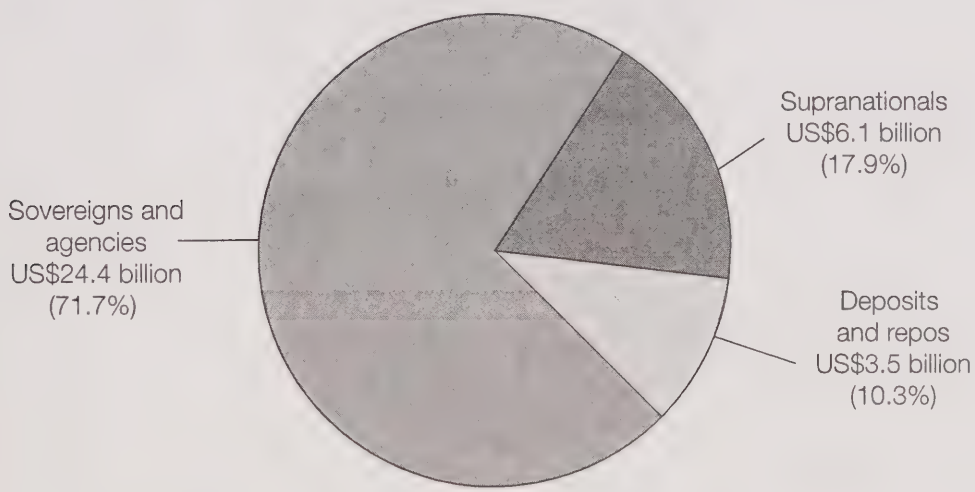
Investment Policy

The policy governing the management of assets, set out in the SIP, is designed to achieve the strategic objectives of maintaining a high standard of liquidity, preserving capital value and optimizing return. To achieve these goals, the policy is to invest primarily in securities (bonds and bills) issued by sovereigns and their agencies or supranationals denominated in US dollars, euro and yen. Reserves can also be invested in cash deposits with financial institutions and in US-dollar tri-party repurchase agreements (repos). The SIP sets limits pertaining to issuers and counterparties across all lines of business, requires diversification of assets and counterparties, and defines high liquidity standards and the allowable maturities of reserve asset classes.

The investment policy splits investments into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the core liquidity requirements in foreign currencies. It consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

In practice, the EFA portfolio is mainly invested in sovereign and agency securities (72 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).[4] The share of deposits and repos is small because they offer lower returns than other investment options. The Liquidity Tier mainly consists of US Treasury securities, given that they are the most liquid securities in the market.

Chart 1
Composition of EFA Liquid Investments as at March 31, 2006
(market value)



Note: Does not add to 100% due to rounding.

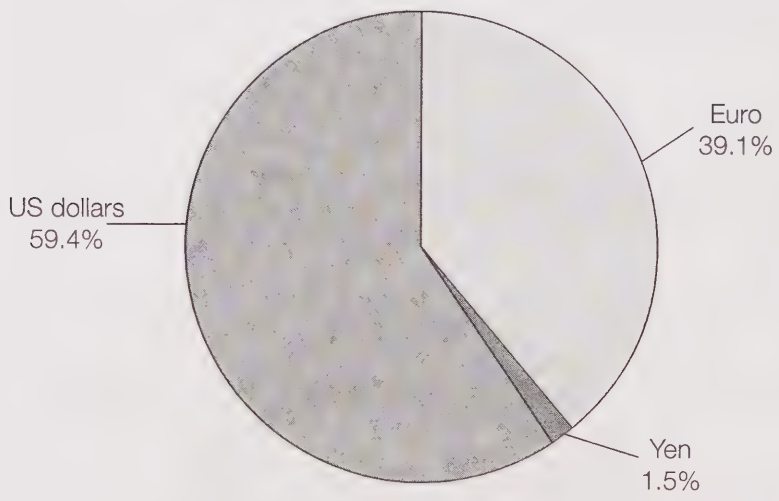
4 Excludes gold, SDR holdings, as well as cash in the Bank of Japan and the Bank for International Settlements (BIS). Deposits with the BIS are included in supranationals in Chart 1.

The current practice is to hold a significant portion of the reserves in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange intervention has mainly consisted of transactions involving the US dollar. As at March 31, 2006, the US-dollar share of the EFA portfolio was US$20.2 billion or 59.4 per cent, the euro share was 11.0 billion euros or 39.1 per cent, and the yen portion was 59.8 billion yen or 1.5 per cent (Chart 2).[5]

Asset-Liability Management Policy

Foreign currency reserve assets held in the EFA and the Government of Canada foreign currency liabilities identified as financing those assets are managed on a portfolio basis, and are matched as closely as possible in currency and duration, so that the net exposure to currency and interest rate risks is limited. The target is to minimize the gap between the market value of assets and liabilities, as monitored on a daily basis, to within a range of +/- US$300 million.

Chart 2
Currency Composition of the EFA
as at March 31, 2006
(market value)



[5] Excludes gold and SDR holdings.

Risk Management Policy

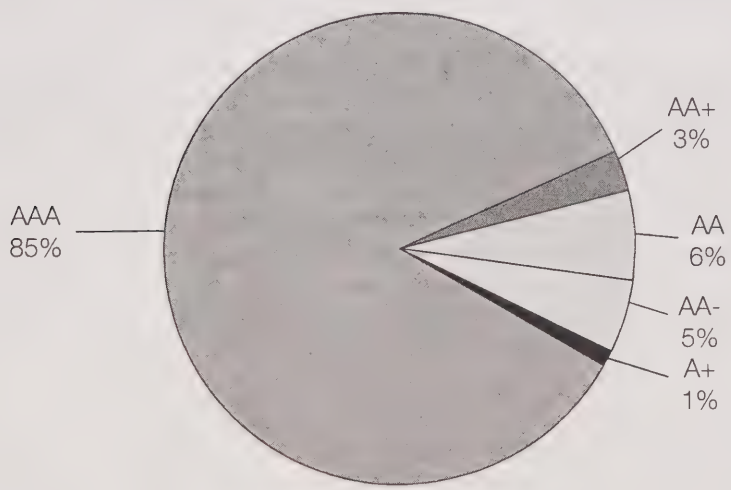
Risk management policy requires identifying and managing treasury risk, including credit, liquidity, legal, market and operational risks related to the financing and investment of the foreign exchange reserves, and regular and timely reporting of risk exposures. For more details, please consult the *Government of Canada Treasury Risk Management Framework* at www.fin.gc.ca/treas/frame/gctrmf06_e.html.

A number of methods are used for measuring financial risk exposures and to ensure compliance with guidelines and specific risk policies. Credit risk is the most important risk faced by the EFA and is controlled by setting limits on both actual and potential exposures[6] to counterparties. There is an ongoing assessment of the credit status of the counterparties using ratings provided by third-party credit rating agencies.

To be eligible for EFA investments, an entity must have a credit rating of at least A-/A3 (see Annex 1 for details). The majority of EFA investments are in the AAA category, as indicated in Chart 3.[7]

Counterparty limits are established based on external ratings, and compliance with counterparty limits is monitored on a real-time basis. In addition, a number of new credit risk measures were adopted in 2005. They are described in more detail in the box entitled "Enhanced Performance Measurement and New Risk Measures" at the end of this section.

Chart 3
EFA Investments by Credit Rating
as at March 31, 2006



6 Actual exposure is a measure of losses that could be incurred if a counterparty defaults today. Potential exposure is a measure of potential losses that would arise from the time of default for a derivatives transaction until that contract could be replaced in the market.

7 Excludes gold and SDR holdings.

Collateral management frameworks are used for managing the credit risk to financial institution counterparties, taking into account any exposure from unsecured deposits. Under these frameworks, high quality collateral (e.g. cash and US Treasury or Government of Canada securities) is placed with the EFA when the current market value of the contract exceeds specified limits on the 1st and the 15th days of each month.

A Value-at-Risk (VaR) model and various stress tests that are considered to be industry standards are also employed to measure the EFA's exposure to market risk. VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from normal market movements, i.e. changes in interest and exchange rates, while stress tests are used for evaluating portfolio performance under extraordinary circumstances in the market.

Risk measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada. The Minister of Finance receives an annual report on treasury risk management that is prepared in collaboration with the Bank of Canada's Financial Risk Office.

Performance Measurement Policy

Performance measurement policy provides a framework for measuring, analyzing and evaluating financial performance of EFA investments and associated liabilities. The policy requires regular and timely reporting to senior management, the Minister and Parliament of the returns on EFA assets and the costs of associated liabilities.

The principal measure is based on accounting information (revenues and the net carry measure), supplemented by an economic yield-based measure of asset-liability performance called total return. In addition, liability benchmarks, external indices and attribution analysis are used to measure portfolio performance.

Asset-liability performance is reported on a monthly basis to management at the Department of Finance and the Bank of Canada, periodically to the Minister of Finance and annually to Parliament. As required by the *Currency Act*, the Office of the Auditor General audits the financial statements of the EFA and reports to the Minister annually on a fiscal-year basis.

Enhanced Performance Measurement and New Risk Measures

New measures and methodologies to enhance performance and risk reporting were introduced during the reporting period. These measures have been adopted based on leading industry standards (see the sections "Portfolio Performance Measurement" and "Risk Measures" for detailed results).

Enhanced Performance Measurement

Until recently, the return on the liability portfolio was the only measure used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). To supplement this information, external asset indices for the EFA portfolio have recently been introduced to enhance the understanding of the performance of the EFA in relation to broader market developments, and to provide some insight into additional returns earned from investing in a broader range of assets. The new asset indices for the EFA, based on Merrill Lynch composite indices, provide an independent comparator for the performance of the EFA portfolio broken down by currency denomination.

Performance attribution analysis determines by how much each contributing variable impacts total return, as explained in more detail below. Results are calculated for both assets and liabilities, as well as for each currency, on a net basis.

- *Coupon effect* measures the return that would have been earned had interest rates remained unchanged over the period.
- *Yield curve effect* measures the impact on returns due to changes in the general level of interest rates over the period.
- *Spread effect* measures the impact on returns due to movements in interest rate spreads over the period.
- *Securities-lending revenue* measures the return from lending US Treasury securities held in the EFA.
- *Residual returns* are the difference between the actual return and the sum of the above effects.

New Risk Measures

Credit Value-at-Risk (credit VaR) is a statistical measure that was developed for estimating the maximum expected loss over a specified time period (i.e. one year) as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. An associated measure, expected shortfall, indicates the potential losses to the EFA due to extreme, unexpected credit events occurring in the same period. The EFA's credit VaR model was validated by a Bank for International Settlements (BIS) expert in October 2005. The expert concluded that the model reflects best practice, input assumptions are appropriately conservative and the results of the model are reliable. Suggestions made by the BIS expert for improving the model have since been incorporated.

Credit risk stress tests are carried out to evaluate potential losses to the EFA arising from serious credit events in the market. They subject the EFA to a range of hypothetical extreme scenarios, allowing risk managers to assess how well the EFA would withstand a ratings downgrade of one notch and other selected credit event scenarios in the market.

Review of Operations

This section reviews operations related to the official international reserves, including the achievement of objectives, major initiatives undertaken, changes in the level of reserves, portfolio performance and risk measurements.

Performance Versus Strategic Objectives

The amended *Currency Act* stipulates that this report provide a statement of whether the strategic objectives have been met during the review period. The three objectives, which are to maintain a high standard of liquidity, preserve capital value and optimize return, have been achieved, as the level of liquidity was maintained for the reserves portfolio throughout the reporting period, and the portfolio's exposure to market and credit risks remained stable (see the section entitled "Risk Measures"). In addition, both cost of carry and total return measures were positive (see the section entitled "Portfolio Performance Measurement").

Major Initiatives

During this period, major initiatives focused on implementing legislative changes and on setting out the EFA's investment policy in the *Statement of Investment Policy*. Several reviews were also undertaken to ensure that programs continue to operate effectively, to identify areas of improvement, and to ensure that operational practices are in line with industry standards.

Review of the Tri-Party Repo Program

The US-dollar tri-party repo program, introduced in April 2003, is a collateralized short-term US-dollar investment program that provides an alternative to unsecured deposits with financial institutions. A review of the operational parameters of the program identified several adjustments to allow it to better achieve its objectives and to bring it more in line with private sector industry standards. The changes should result in an increase in the number of repo dealers participating in the program and enable the size of the program to be increased, reducing the reliance on unsecured deposits with financial institutions as a short-term investment vehicle.

Review of the Cross-Currency Swap Program

Since its inception in 1995, the cross-currency swap program has been the most cost-effective measure of funding foreign currency investments. As of March 31, 2006, cross-currency swaps of domestic obligations accounted for over 60 per cent of liabilities used for funding the EFA. Due to its growing importance, an overall review of the cross-currency swap program was undertaken. The review examined the effectiveness of several risk guidelines limiting credit risk exposure to swap counterparties, as well as the operational aspects of the program. In addition, a *Swap Management Policy* (SMP) was approved by the Minister in September 2006. The SMP sets out the policy for swaps used to manage the liability structure of the marketable debt and documents the governance of the cross-currency swap program.

External Evaluation of the EFA

An external review of the EFA was launched in December 2005 focusing on the EFA portfolio structure, investment guidelines, asset eligibility, performance measurement metrics and reporting. The evaluation process involves a comparison of the EFA's investment framework with the general investment practices of similar large, public sector institutional investors. The evaluator's report will be released publicly in 2006.

Treasury Risk Management Framework

To further enhance accountability and the transparency of treasury risk management policies and practices, the *Government of Canada Treasury Risk Management Framework* was prepared and posted on the Department of Finance website www.fin.gc.ca/treas/frame/gctrmf06_e.html. This reference document provides detailed information on the risk management framework within which the Government's liquid financial assets and marketable debt are managed.

Market Developments During the Reporting Period

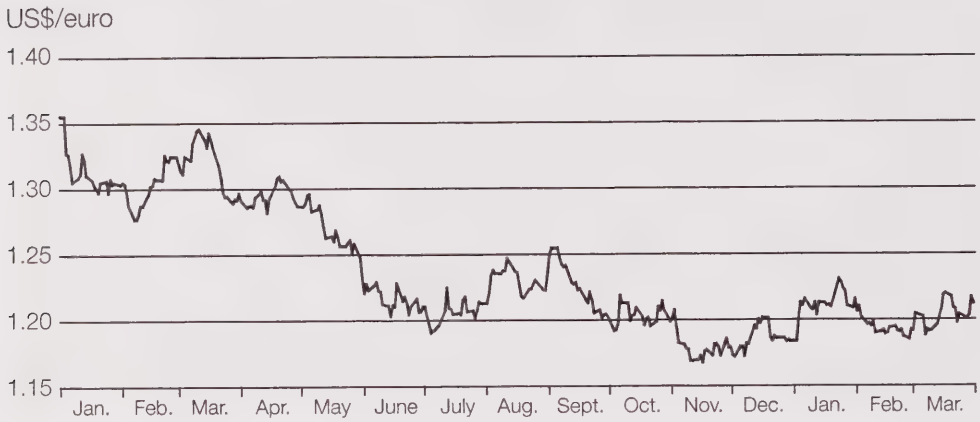
As the official international reserves are reported on a market-value basis and in US dollars, changes in interest and exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates)[8] will affect the level of the reserves.

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the value of the investments held in the reserves. Over the 15-month period from January 1, 2005 to March 31, 2006, movements in interest rates had a smaller effect on the reserves than movements in exchange rates: changes in interest rates reduced the market value of the reserves by US$706 million, while foreign currency revaluations reduced their market value by US$1.9 billion.

As roughly 39 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2006), the market value of the reserves was significantly affected by movements in the euro. From January 1, 2005 to March 31, 2006, the euro depreciated 10.6 per cent against the US dollar. The high for the period was 1.3550 (US dollar/euro) on January 1, 2005, while the low was 1.1675 on November 16, 2005 (Chart 4).

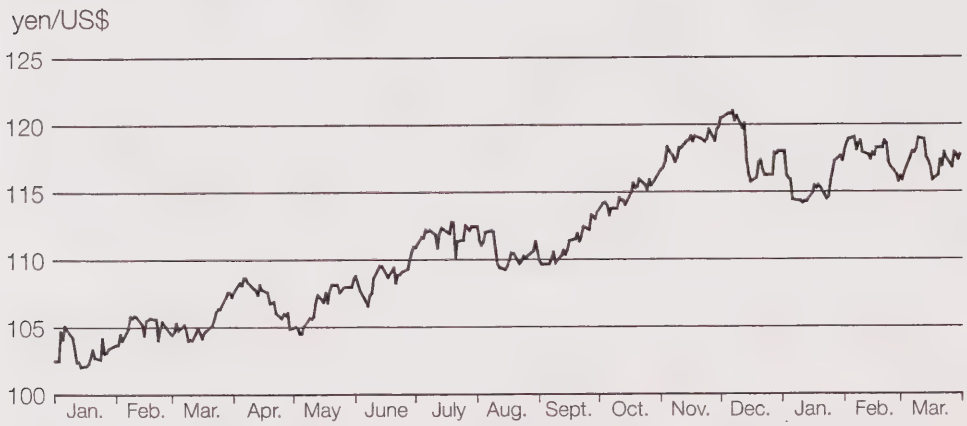
[8] Charts 4 and 5 show the US dollar exchange rates for the euro and yen, where in accordance with market practice the euro is quoted in US-dollar terms (i.e. how many US dollars are required to buy 1 euro) and the yen is quoted in yen terms (i.e. how many yen are required to by 1 US dollar). Both charts reflect an increase in the US dollar.

Chart 4
The Evolution of the Euro From January 1, 2005 to March 31, 2006



The official international reserves were less exposed to changes in the yen/US-dollar exchange rate (Chart 5) since only 1.5 per cent of the reserves were held in yen-denominated assets (as at March 31, 2006). Overall, the yen depreciated by 14.8 per cent against the US dollar during the reporting period. The high for the period was 102.04 on January 14, 2005, and the low was 120.98 on December 7, 2005.

Chart 5
The Evolution of the Yen From January 1, 2005 to March 31, 2006



Composition of the Official International Reserves at March 31, 2006

Table 2 shows the term structure of investments in the official international reserves by currency and term to maturity as at March 31, 2006. US-dollar holdings, which made up more than half of the reserves, were primarily in short-term (i.e. under six months) maturities, as they are held for liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards medium-term (i.e. one to five years) investments. Likewise, the yen holdings were mostly invested in securities with medium-term maturities.

For reporting purposes, gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars. The IMF reserve position is classified as an investment of indefinite term.

Table 2

Term Structure of the Official International Reserves as at March 31, 2006

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Total official international reserves
				(market value in millions of US dollars)				
US-dollar holdings								
Under 6 months	5,447	2,720	5,639	–	–	**13,806**	–	**13,806**
6 to 12 months	–	–	432	–	–	**432**	–	**432**
1 to 5 years	–	–	2,674	–	–	**2,674**	–	**2,674**
Over 5 years	–	1,049	2,242	–	–	**3,291**	–	**3,291**
Indefinite term	–	–	–	63	917	**980**	1,038	**2,018**
Total US-dollar holdings	5,447	3,769	10,987	63	917	**21,183**	1,038	**22,221**
Euro holdings[1]								
Under 6 months	78	368	–	–	–	**446**	–	**446**
6 to 12 months	–	142	64	–	–	**206**	–	**206**
1 to 5 years	–	7,219	1,873	–	–	**9,092**	–	**9,092**
Over 5 years	–	2,915	645	–	–	**3,560**	–	**3,560**
Total euro holdings	78	10,644	2,582	0	0	**13,304**	0	**13,304**
Yen holdings[1]								
Under 6 months	71	–	–	–	–	**71**	–	**71**
6 to 12 months	–	–	–	–	–	**–**	–	**–**
1 to 5 years	–	438	–	–	–	**438**	–	**438**
Over 5 years	–	–	–	–	–	**–**	–	**–**
Total yen holdings	71	438	0	0	0	**509**	0	**509**
Total	5,596	14,851	13,569	63	917	**34,996**	1,038	**36,034**

[1] The exchange rates prevailing on March 31, 2006, are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

As shown in Table 3, Canada's official international reserves as at March 31, 2006, were US$36.0 billion (on a market-value basis), up from US$34.5 billion as at December 31, 2004. The sources of changes are provided in the next section.

Table 3

Canada's Official International Reserves Holdings as at March 31, 2006

		Total official international reserves			
	Total official international reserves as at December 31, 2004	EFA	IMF reserve position	Total official international reserves as at March 31, 2006	Change
	(market value in millions of US dollars)				
Securities	**27,834**	28,420	–	**28,420**	586
Deposits[1]	**2,333**	5,596	–	**5,596**	3,263
Gold	**48**	63	–	**63**	15
Special drawing rights	**925**	917	–	**917**	-8
IMF reserve position	**3,327**	–	1,038	**1,038**	-2,289
Total	**34,467**	34,996	1,038	**36,034**	1,567

[1] The figure as at December 31, 2004 includes the Bank of Canada and Receiver General accounts, totalling US$0.1 billion.

Sources of Changes

The level of the official international reserves changes over time due to a variety of factors. As shown in Table 4, over the 15-month reporting period the level of the reserves increased by US$1.6 billion due to reserves management operations (US$4.4 billion) and return on investment (US$0.6 billion). The increase was partly offset by foreign currency debt charges (US$1.5 billion) and revaluation effects (US$1.9 billion).

Table 4

Sources of Changes in Canada's Official International Reserves (December 31, 2004 to March 31, 2006)

	Change
	(market value in millions of US dollars)
Official intervention	–
Net government operations	–
Reserves management operations	4,372
Gains and losses on gold sales	–
Return on investments	613
Foreign currency debt charges	-1,513
Revaluation effects	-1,903
Total change	1,567

Note: Numbers do not add due to rounding.

Official Intervention

Official intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and would therefore affect the level of the official international reserves. Intervention in the Canadian-dollar foreign exchange market has not occurred since 1998 (see Annex 2).

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements will affect the official international reserves. There were no net government operations during the reporting period.

Reserves Management Operations

Matched debt issues/maturities and purchases/sales of foreign currency assets affect the level of the EFA. Over the 15-month reporting period, funds raised through the issuance of cross-currency swaps and Canada bills, totalling US$10.6 billion, more than offset debt maturities (US$6.2 billion in total, including a US$1.5-billion global bond, a Canada note maturity totalling US$430 million and cross-currency swap maturities of US$4.3 billion), resulting in a net increase in the level of official international reserves.

Gains and Losses on Gold Sales

This factor reflects the difference between the value of gold holdings at the beginning and the end of the reporting period due to gold sales and a change in the market value of gold. There were no gold transactions during the period, with the last of the Government's gold bullion holdings having been sold in December 2003.

Return on Investments

Return on investments comprises interest earned on investments (US$1.3 billion) and the decrease in the market value of securities resulting from changes in interest rates (US$0.7 billion). The overall effect on the official international reserves was a net increase of US$0.6 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by US$1.5 billion.

Revaluation Effects

Revaluation effects resulting from movements in exchange rates reflect changes in the market value of the official international reserves. Revaluation effects reduced the official international reserves by US$1.9 billion, primarily due to the depreciation of the euro versus the US dollar.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Annex 3.

EFA Financing

As previously noted, the assets in the EFA are managed against a portfolio of dedicated liabilities. These are Government of Canada foreign currency borrowings from a variety of sources (Table 5).

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap issuance and maturities during the reporting period were US$8.0 billion and US$4.3 billion, respectively. Swaps are particularly cost-effective compared to other sources of foreign currency funds. Foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 35 basis points on average.

In addition to cross-currency swaps of domestic obligations, the EFA is funded by a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and euro medium-term notes) and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From December 31, 2004 to March 31, 2006, the level of outstanding Canada bills increased by US$2.6 billion. Canada bills were issued, on average, at an all-in cost of US$ LIBOR less 20 basis points, which was generally in line with funding levels of prior years. There was no new issuance of Canada notes, euro medium-term notes or global bonds during the period. One US-dollar global bond (US$1.5 billion) and one Canada note (US$430 million) matured.

The changes in the outstanding numbers shown in Table 5 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars).

Table 5

Outstanding Foreign Currency Issues as at March 31, 2006

	December 31, 2004	March 31, 2006	Change
	(par value[1] in millions of US dollars)		
Swapped domestic issues	19,378	22,083	2,705
Global bonds	8,131	6,286	-1,845
Canada bills	1,424	4,053	2,629
Euro-medium term notes	1,434	1,284	-150
Canada notes	976	425	-551
Total	31,343	34,131	2,788

[1] Liabilities are stated at the exchange rates on December 31, 2004 and March 31, 2006.

Further information on the management of foreign currency liabilities and the associated credit risks can be found in the *Debt Management Report* at www.fin.gc.ca/purl/dmr-e.html.

Portfolio Performance Measurement

Revenues

The revenues of the official international reserves include income from investments and foreign exchange gains. During the reporting period, income totalled C$1.7 billion, compared to C$1.8 billion in 2004. The main categories of income are summarized in Table 6. Data is reported in Canadian dollars, as EFA revenues, which account for the bulk of the revenues of the official international reserves, are reported in Canadian dollars in the attached financial statements.

Table 6

Revenues for the Official International Reserves as at March 31, 2006

		Official international reserves		
	2004 total revenue	EFA	IMF reserve position	Total revenue from January 1, 2005 to March 31, 2006
	(millions of Canadian dollars)			
Investment income				
Marketable securities	**1,588**	1,840	–	**1,840**
Cash and short-term deposits	**34**	104	–	**104**
Deposits held under repurchase aggreements	**3**	46	–	**46**
Special drawing rights	**21**	37	–	**37**
IMF reserve position	**–**	–	–	**–**
Total investment income	**1,646**	2,027	–	**2,027**
Other income				
Net gain on sales of gold	**–**	–	–	**–**
Foreign exchange gains (losses)	**154**	-293	–	**-293**
Total income	**1,800**	1,734	–	**1,734**

The EFA's securities-lending program enhances the income earned on the portfolio by lending out securities that are highly sought after in the market. At year-end, C$3.4 billion (par value) in US government securities were held by the two financial institutions that act as agents and mandataries (see Annex 4) for lending these securities to market participants. Income from securities lending, included in investment income from marketable securities in Table 6, totalled C$8.4 million during the period compared to C$2.6 million in 2004.

Net Return Measures

As the EFA is managed on an integrated asset-liability basis, from an economic perspective, the key measures of portfolio performance net the performance of assets and liabilities. Two principal measures of performance are used: carry and total return.

Carry is an accounting-based measure expressed in dollar and yield terms estimated by subtracting the interest earned on assets from the interest paid on Canada's foreign currency liabilities (i.e. the net interest earned or paid). Total return, expressed as a yield based on market values, is calculated for both the assets and the liabilities and for each currency, with the return on the liability portfolio being used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). Performance of the assets is also compared to an external index in order to provide an independent measure of the performance of the EFA and to enhance the understanding of performance in relation to broader market developments. Performance according to both measures is presented below.

Carry

Table 7 provides an estimate of the carry for the official international reserves and for segments of the reserves. The carry for the 15-month reporting period is estimated at -49 basis points, which is lower than in 2004. The negative performance is due to the holding of low-coupon assets relative to the interest paid on the liabilities.

Taking into account gains/losses on asset sales, during the same period, the Government earned net revenues of US$75 million, or 25 basis points, which reflects US$227 million in net realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$152 million. The EFA realized US$9 million in gains on US-dollar asset sales and US$218 million in gains on euro asset sales. Realized gains were significant due to sales of high-coupon assets in a low interest-rate environment. As a result, the net carry is estimated at +25 basis points, similar to the net carry achieved in calendar year 2004.

Table 7

Carry for the Official International Reserves[1]

	2004		January 1, 2005 to March 31, 2006				
	Carry	Carry (including net realized gains)	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry	Carry (including net realized gains)
	(basis points)		(millions of US dollars)			(basis points)	
Euro portfolio	-7.2	19.7	617.2	706.8	-89.6	-29.0	41.6
Yen portfolio	–	–	13.8	13.8	0	0	0
US$ portfolio	-13.4	5.3	797.5	859.6	-62.1	-20.1	-17.1
EFA[2]	**-20.6**	**25.0**	**1,428.5**	**1,580.2**	**-151.7**	**-49.1**	**24.5**
IMF reserve position	1.5	1.5	–	–	–	–	–
Total carry	**-19.1**	**26.5**	**1,428.5**	**1,580.2**	**-151.7**	**-49.1**	**24.5**

[1] The carry figures show the contribution of each currency portfolio to the overall carry. Numbers for 2005–06 do not include the IMF reserve position and associated liabilities. Including the IMF reserve position for the 15-month reporting period would have decreased the carry of the EFA by about 8 basis points.

[2] Excludes gold holdings.

In December 2005, the decision was taken to remove the IMF reserve position and the liabilities that fund it from EFA portfolio performance measures, as it is not actively managed. The inclusion of the IMF position in EFA performance measures was also introducing volatility in returns, as the IMF position is not currency matched (i.e. the IMF position is denominated in special drawing rights and funded with US-dollar liabilities), distorting measures of performance of the actively managed portfolio. This segregated reporting approach is consistent with that of other central banks.

Total Return On Market-Value Basis

Table 8 provides an estimate of the total return on a market-value basis for the EFA as a whole and its key portfolios compared to the corresponding liabilities.[9] The net total return was +17 basis points, or US$44 million, in the 15 months ending March 31, 2006 compared to +20 basis points in 2004. This reflects net returns in US dollar terms of +23 basis points for the US-dollar portfolio, +14 basis points for the euro portfolio and -3 basis points for the yen portfolio. These numbers include interest flows as well as all gains/losses earned over the period, regardless of whether they were realized or not.

[9] Excluding gold, SDR holdings and the IMF reserve position as those assets are not actively managed on an integrated asset-liability basis. Including the IMF reserve position and SDRs would have reduced the EFA total return by about 6 basis points in the 15 months ending March 31, 2006.

Table 8

Total Return for the EFA Compared to Liability Benchmarks

	2004	January 1, 2005 to March 31, 2006			
	Total EFA	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio					
Return in original currency	**n/a**	3.02%	1.78%	-0.45%	**n/a**
Return in US$ (A)	**7.74%**	3.02%	-8.99%	-13.31%	**-3.42%**
Liability benchmarks					
Return in original currency	**n/a**	2.79%	1.62%	-0.41%	**n/a**
Return in US$ (B)	**7.74%**	2.79%	-9.13%	-13.28%	**-3.60%**
Return vs. liability benchmark in basis points (A – B) in US$	**20**	23	14	-3	**17**

Table 9 compares the total return for the EFA to a set of Merrill Lynch government securities indices. This provides insight into how it compares to a portfolio invested strictly in US Treasury and German government securities. While the indices have been combined and weighted to reflect the currency composition and duration of the EFA, they provide only a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the 15 months ending March 31, 2006, the EFA's total return was within 2 basis points of the weighted average return of these indices.

Table 9

Total Return for the EFA Compared to External Indices[1]

	January 1, 2005 to March 31, 2006			
	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio				
Return in original currency (A)	3.02%	1.78%	-0.45%	**n/a**
Return in US$	3.02%	-8.99%	-13.31%	**-3.42%**
External indices				
Return in original currency (B)	2.80%	2.04%	-0.41%	**n/a**
Return in US$	2.80%	-8.75%	-13.28%	**-3.40%**[2]
Return vs. external indices in basis points (A – B) in original currency	22	-26	-4	**-2**

[1] Composite indices are constructed as weighted averages of Merrill Lynch US Treasury and German government indices.

[2] Return versus external indices is expressed in original currency except for the total EFA, where both assets and index returns are converted to US dollars.

Performance Attribution

In 2005, a new performance attribution system was introduced that decomposes the total market-value return of the EFA's portfolios into key sources of return. They include: returns that would have been earned had interest rates remained unchanged over the period (coupon effect); the impact of changes in the general level of interest rates (yield curve effect); returns due to movements in interest rate spreads (spread effect); revenue obtained from securities lending; and residual returns. The analysis is performed on the original currency returns of the US-dollar and euro portfolios and their corresponding liabilities.

Table 10 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the 15 months ending March 31, 2006. They indicate the coupon effect was the main source of original currency return for both portfolios. Although total returns on both portfolios were undermined by rising interest rates over the period, similar effects were observed in the corresponding liabilities, confirming that assets and liabilities are closely matched in terms of their sensitivity to movements in interest rates. The US-dollar portfolio also earned 4 basis points from securities-lending activities over the period, since many of its securities were in high demand in the market.

Table 10

Performance Attribution for the US-Dollar and Euro Portfolios[1]
Compared to Liability Benchmarks

	January 1, 2005 to March 31, 2006			
	US$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	4.97	4.77	3.46	3.32
Yield curve effect	-2.39	-2.13	-1.89	-2.01
Spread effect	0.39	0.10	0.26	0.25
Securities-lending revenue	0.04			
Residual returns	0.01	0.05	-0.05	0.06
Return in original currency	3.02	2.79	1.78	1.62

[1] Please refer to the box entitled "Enhanced Performance Measurement and New Risk Measures" earlier in this document for the definitions of the performance attribution variables.

Risk Measures[10]

The risk management framework covers market, credit, liquidity, legal and operational risks related to the financing and investment of the foreign reserves.

Market Risk

Several industry-standard measures of market risk exposure were employed: scenario analysis, stress testing and Value-at-Risk (VaR) (Table 11).

Stress tests were regularly carried out to gauge the sensitivity of the EFA portfolio to changes in exchange rates and interest rates, including the portfolio impact of a 1-per-cent depreciation of the euro and yen vis-à-vis the US dollar and a 1-per-cent increase in interest rates across the yield curve. The results showed that, on a net basis during the reporting period, the EFA assets and the associated liabilities had very minimal exposure to currency depreciations and upward shifts in the yield curve, comparable to their positions as at December 31, 2004.

In addition, some hypothetical scenario stress tests that mimic the market conditions during four previous extraordinary market events were regularly conducted: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The four stress tests showed that the EFA would generally perform well during such periods of market turbulence. The results were similar to those reported for December 31, 2004, and show that on a net basis, the EFA was continuously well positioned to benefit from flight-to-quality effects.

Table 11

Market Risk Measures

	December 31, 2004		March 31, 2006	
Risk measure	EFA	EFA assets less liabilities	EFA	EFA assets less liabilities
	(millions of US dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-157	-2	-138	-2
1% upward parallel shift in yield curve	-797	-5	-801	2
Scenario tests				
1994 Fed tightening	-2,345	12	-2,198	85
1997 Asian financial crisis	-814	48	-713	54
1998 Russian default/LTCM collapse	-1,149	68	-989	45
2001 terrorist attacks	993	38	889	14
99% 10-day VaR	1,103	18	609	14

[10] These risk measures apply to the EFA only, excluding the SDRs and gold holdings.

The market VaR is a statistical measure that estimates the maximum expected loss in portfolio value within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is regularly reported on the entire EFA portfolio and on the net position between assets and liabilities. As of March 31, 2006, the EFA had a 99-per-cent 10-day VaR of US$14 million, slightly lower than at December 31, 2004, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than US$18 million, on a net basis, over a 10-day period.

Credit Risk

The new credit VaR model and some selected credit risk stress tests were used to measure the EFA's exposure to credit risk during the reporting period (Table 12).

Table 12
Credit Risk Measures

Risk measure	March 31, 2006
	(millions of US dollars)
Credit VaR and expected shortfall	
99.9% 365-day credit VaR	427
Expected shortfall	1,357
Stress test	
Potential loss if counterparties with negative outlook are downgraded one notch	0.646

The credit VaR estimated the maximum expected loss in portfolio value within a year as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. As of March 31, 2006, the EFA had a 99.9-per-cent 365-day credit VaR of US$427 million, which implied that 99.9 per cent of the time, the value of the portfolio was not expected to decline by more than US$427 million over a 365-day period due to credit events. An associated measure, expected shortfall, computes the expected average loss in portfolio value during the same period due to an extreme, unexpected credit event, whose possibility of happening (less than 0.1 per cent) was not captured by the credit VaR statistic. The expected shortfall measure for the EFA was US$1.4 billion as of March 31, 2006.

Credit risk stress tests were also carried out to evaluate potential losses to the EFA assets and the associated liabilities arising from extraordinary credit events in the market. These tests subjected the EFA to hypothetical scenarios, such as all counterparties with a negative outlook being downgraded by one notch. They showed that the EFA would continuously perform well in this type of scenario.

Annex 1: Statement of Investment Policy *(Effective as of September 2006)*

1. Purpose of Policy

This document sets out the policy, approved by the Minister of Finance under the *Currency Act*, governing the acquisition, management and divestiture of assets for the Exchange Fund Account (EFA).

2. Purpose of EFA

The Exchange Fund Account is the principal repository of the Government of Canada's official international reserves. Its purpose is to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market and to provide foreign currency liquidity for the Government of Canada.

3. Governance

Part II of the *Currency Act* governs the management of the EFA. As amended in 2005, the act requires the Minister of Finance to establish an investment policy for EFA assets. Responsibility for the implementation of approved policy and strategy is delegated to officials of the Department of Finance and the Bank of Canada. Details of the governance framework are provided in the *Treasury Management Governance Framework*.

4. No Inconsistent Business or Activity

This policy prohibits any business or activity that is inconsistent with the investment objectives set forth below or in a manner that is contrary to the *Currency Act*.

5. Investment Objective

There are three investment objectives:

- *Maintain a high standard of liquidity:* Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- *Preserve capital value:* Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis[11] (in terms of currency and duration), and using appropriate practices to mitigate risks.
- *Optimize return:* Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

[11] Liabilities, which fund EFA assets, are managed outside the EFA.

6. Investment Policy

6.1 Eligible Asset Classes

The EFA may hold the following classes of assets: 1) fixed income securities (including bonds, notes, bills and short-term discount notes/commercial paper) issued by sovereigns (including directly guaranteed agencies), central banks, government-supported entities and supranational institutions; 2) deposits with commercial banks, central banks and the Bank for International Settlements; 3) repurchase agreements; 4) commercial paper and certificates of deposit issued by private sector entities; 5) gold; and 6) International Monetary Fund (IMF) special drawing rights. Subject to section 6.9, bonds with embedded options (such as callable bonds) and holdings of securities issued by and deposits with Canadian-domiciled entities (or entities that derive a majority of their revenues from their Canadian operations) are not permitted. All other classes of assets not listed in this policy are prohibited.

6.2 Eligible Investment Ratings

Eligibility for investment in the EFA is based on external credit ratings. To be eligible for investment, an entity must have a credit rating in the top seven categories from at least two of the four main rating agencies: Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. When there are two or more ratings for an entity, the rating of the second highest rating agency will be used to assess eligibility.[12]

The only allowable unrated investments are the following: a) securities issued by and deposits with central banks and the Bank for International Settlements and b) investments in special drawing rights created by the IMF.

Ratings agency	Minimum rating
Moody's Investors Service	A3
Standard & Poor's	A-
Fitch Ratings	A
Dominion Bond Rating Service	A (low)

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

[12] However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).

6.3 Credit Exposure Limits

Exposure limits are based on credit quality for classes of assets, aggregate and individual counterparties.

6.3.1 Fixed Income Securities

Exposure to fixed income securities issued by sovereigns (including directly guaranteed agencies), government-supported entities and supranational institutions are determined by credit rating and by currency of issuance, as shown in the table below.

Issuer	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies) and AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
A- to A+ sovereigns (including directly guaranteed agencies)	2	See below[1]
Government-supported entities (senior unsecured obligations)	15	3
Supranationals (excluding Bank for International Settlements)	25	10

Note: All amounts are expressed in par values.

[1] *Individual exposure limits for single-A sovereigns (including directly guaranteed agencies) are as follows:*

Credit rating	Total exposure	Of which home currency	Of which foreign currency
		(millions of US dollars)	
A+	500	500	50
A	250	250	25
A-	100	100	10

Note: All amounts are expressed in par values.

6.3.2 Deposits and Other Short-Term Securities

Aggregate and individual exposure limits exist for deposits and other eligible securities. A maximum of 10 per cent of the reserves target level (based on par values) may be invested in deposits and securities of the Bank for International Settlements. Aggregate limits of US$1.5 billion and US$1 billion (based on par values), respectively, are imposed on commercial bank deposits and commercial paper/certificates of deposit issued by private sector entities.

Individual exposure limits to private sector entities in the form of forwards, deposits, commercial paper and certificates of deposit, together with swaps used for funding purposes, are determined by credit rating, as shown in the following table. These limits are cumulative across all lines of business and represent the mark-to-market value for swaps and forwards and the par-value exposure for deposits, commercial paper and certificates of deposit. Total exposure to private sector entities may not exceed 25 per cent of the reserves target level, with a maximum of 2 per cent of the reserves target level for private sector entities rated A+ to A-.

Actual exposure limits by credit rating of private sector counterparties/issuers[1]

	AAA	AA+	AA	AA-	A+	A	A-
				(millions of US dollars)			
Individual exposure	300	200	150	100	50	25	10

[1] Represents par value for deposits, commercial paper and certificates of deposit and mark-to-market value for swaps and forwards.

6.4 Structure of EFA Holdings

Investments will be held in either a Liquidity Tier or an Investment Tier. Only highly liquid US-dollar-denominated securities are eligible for investment in the Liquidity Tier: 1) sovereign (including directly guaranteed agencies) and supranational securities; 2) US government-supported entity securities; 3) US and European government-supported entity discount notes and commercial paper; 4) callable Bank for International Settlement deposits and medium-term investments; 5) overnight commercial bank deposits; 6) commercial paper and certificates of deposit issued by private sector entities; and 7) overnight repurchase agreements.

6.5 Eligible Currencies

The Exchange Fund Account may hold US dollars, euros, Japanese yen and IMF special drawing rights. The minimum floor for US-dollar-denominated securities is US$12 billion on a market-value basis.

6.6 Terms of Investments

The maximum term to maturity of EFA assets is based on type of instrument, credit rating and currency of issuance, as shown in the following table.

Instrument	Maximum term to maturity
Marketable securities from issuers rated AA- or better	10.5 years
Investments from issuers rated A+ or lower	5 years if the investment is denominated in domestic currency 1 year if the investment is denominated in foreign currency
Commercial paper and certificates of deposit	1 year
Commercial bank deposits and repurchase agreements	3 months

6.7 Permitted Activities

EFA officials may acquire or borrow assets to be held in the EFA and sell or lend those assets. Short sales are prohibited.

6.8 Use of Derivatives

EFA officials may use derivatives to mitigate risk and reduce costs. Derivatives shall not be used to establish speculative or leveraged positions.

6.9 Securities Lending and Repurchase Agreements

EFA officials may lend or borrow securities held in the EFA through a securities-lending program or repurchase agreements to enhance portfolio returns, provided it does not compromise liquidity or engender material exposure to loss. Officials are responsible for appointing and supervising agents, determining eligible collateral and setting collateral margins. Eligible collateral may include, but is not limited to, bonds with embedded options. Officials have the authority to either manage themselves or delegate to an agent the authority to select borrowers, negotiate terms to maturity and rates, and invest cash or securities collateral.

6.10 Exceptions

In exceptional circumstances such as a ratings downgrade or an event of default, the EFA may hold assets (acquired either through direct investment or by taking possession of collateral following an event of default) that do not otherwise meet the criteria for eligible asset classes and/or breach the credit exposure limits, provided that timely efforts are made to divest the EFA of those assets or otherwise bring any such exceptional holdings into compliance.

7. Performance Assessment and Risk Management

Officials are responsible for measuring, monitoring and reporting on the performance and risk exposures of the EFA and tracking these positions against appropriate indices. Performance and risk exposures will be reported on a timely and regular basis to a risk committee that has the capacity to provide an independent view of operations, to a management committee, and to senior management from the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament. Measures should be consistent with leading practices in the private sector and provide information on the returns on EFA assets, the cost of associated liabilities and financial risks. Detailed information on the Government's risk management policies is provided in the *Government of Canada Treasury Risk Management Framework*.

8. Review

The *Statement of Investment Policy* will be reviewed annually and updated as required. Investment programs and practices should be subject to periodic external review to ensure that they contribute effectively to the achievement of EFA objectives.

Annex 2: Official Intervention

Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy; the goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Since September 1998 the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[13] Since that time, the only market intervention was the purchase of euros in 2000 as part of Canada's participation in concerted G7 intervention in support of the euro.

Table 13
Official Intervention

	2001	2002	2003	2004	January 1, 2005 to March 31, 2006
			(millions of US dollars)		
Purchases	–	–	–	–	–
Sales	–	–	–	–	–
Net	–	–	–	–	–

[13] Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.



Annex 3: Canada's Official International Reserves

Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change	Reserves management operations[4]	Gains and losses on gold sales	Return on investments[5]	Foreign currency debt charges	Revaluation effects	Net government operations[6]	Official intervention	Other transactions[7]
						(market value in millions of US dollars)									
2004															
December	28,151 *	2,016	48	925	3,327	34,467	-1,801	-2,963	0	1,176	-1,208	1,193	0	0	1
2005															
January	28,354	2,030	46	905	3,255	34,590	124	715	0	104	-47	-648	0	0	0
February	29,316	2,065	47	925	3,208	35,561	971	813	0	-62	-25	245	0	0	0
March	29,201	2,922	47	916	3,164	36,250	689	1,134	0	48	-115	-378	0	0	0
April	29,398	2,065	47	916	3,176	35,602	-648	-792	0	289	-77	-68	0	0	0
May	29,210	2,058	45	904	2,817	35,034	-568	76	0	160	-55	-749	0	0	0
June	28,909	2,590	48	893	2,484	34,924	-110	278	0	142	-244	-285	0	0	-1
July	27,976	2,314	47	890	2,101	33,328	-1,595	-1,244	0	-110	-242	1	0	0	0
August	27,086	4,146	47	907	2,113	34,299	971	538	0	214	-40	259	0	0	0
September	27,108	3,441	52	900	2,098	33,599	-700	-156	0	-85	-86	-374	0	0	1
October	27,350	3,773	51	898	2,142	34,214	615	906	0	-113	-114	-64	0	0	0
November	26,879	4,333	54	894	2,039	34,199	-15	265	0	63	-65	-278	0	0	0
December	26,741	3,923	56	897	1,401	33,018	-1,181	-1,145	0	107	-228	86	0	0	-1
2006															
January	27,274	3,674	62	907	1,042	32,959	-59	-358	0	-77	-3	379	0	0	0
February	27,125	3,556	61	908	1,034	32,684	-275	-32	0	46	-38	-251	0	0	0
March	28,420	5,596	63	917	1,038	36,034	3,350	3,374	0	-113	-134	222	0	0	1
Total[8]	n/a	n/a	n/a	n/a	n/a	n/a	1,567	4,372	0	613	-1,513	-1,903	0	0	0

1 Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

2 Special drawing right (SDR)-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

3 The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

4 Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

5 Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

6 Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

7 Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

8 Numbers may not add due to rounding.

Annex 4: List of Agents and Mandataries as Defined by the Currency Act

The amended *Currency Act* stipulates that this report include a list of the following agents and mandataries appointed by the Minister under subsection 17.2(3) of the act to perform services concerning the EFA.

RBC Dexia Investor Services and State Street Corporation

RBC Dexia Investor Services and State Street Corporation manage the securities-lending program for the EFA. As the Government's agents and mandataries, they carry out securities lending on behalf of the Government. The program involves loaning a security from the Government to a counterparty, who must eventually return the same security, in order to earn additional return on the portfolio.

Bank of Canada

The Bank of Canada, as specified under the *Bank of Canada Act*, is the fiscal agent for the Government of Canada. As part of its fiscal agency responsibilities, the Bank manages the Government's foreign exchange reserves.

Annex 5: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through Chase Manhattan Bank in New York City. Primary distribution occurs through five dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

euro medium-term note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley Dean Witter. The maturities of EMTNs are not fixed, and can range from short-to long-term. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

repo; repurchase agreement: Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. These transactions are similar to secured loans where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized by other high quality securities. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

special drawing right (SDR): An international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of international currencies.

Exchange Fund Account

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year except, as a result of amendments to the *Currency Act*, the year-end for the Account changed to March 31st.

The Department of Finance establishes policies for the Account's transactions and investments, and for related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
12 June 2006

Auditor General of Canada
Vérificatrice générale du Canada

Auditor's Report

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at 31 March 2006 and the statement of revenue for the 15 month period then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at 31 March 2006 and its revenues and its cash flows for the 15 month period then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
12 June 2006

Exchange Fund Account

Balance Sheet as at 31 March 2006

	31 March 2006	31 December 2004
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 4)	4,239	2,668
Deposits held under repurchase agreements (note 5)	2,278	–
Marketable securities (note 6)	32,855	31,761
	39,372	34,429
Other assets		
Special drawing rights	1,065	1,107
Gold	6	7
Accrued interest and other receivables (note 7)	493	637
	1,564	1,751
	40,936	36,180
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 8)	39,202	34,382
Net revenue for the year	1,734	1,798
	40,936	36,180

Approved:

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Revenue
For the 15 month period ended 31 March 2006

	31 March 2006 (15 months)	31 December 2004 (12 months)
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,840	1,588
Cash and short-term deposits	104	32
Deposits held under repurchase agreements	46	3
Special drawing rights	37	21
	2,027	1,644
Other revenue		
Net gain (loss) on foreign exchange	(293)	154
	(293)	154
Net revenue for the year	1,734	1,798

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to the Financial Statements
15 Month period ended 31 March 2006

(Amounts in the notes to the financial statements are in millions of Canadian dollars, unless otherwise stated.)

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Account are to provide general foreign currency liquidity for the government and to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances.

The net revenue for the year is payable to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the fiscal year in accordance with the *Currency Act*.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in accordance with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances. The advances are provided interest free under the terms and conditions prescribed by the Minister of Finance and the Account reflects only transactions pertaining to the assets of the Account. The significant accounting policies of the Account are set out below.

a) Change in Year-end

Amendments to the *Currency Act* came into effect on 30 December 2005 and included changing the reporting year of the Account, which had been the calendar year, to a fiscal year ending 31 March. The amendments include a transitional provision stipulating that the 15 month period that ends 31 March 2006 is deemed to be the first fiscal year.

b) Basis of Presentation

The purpose of the financial statements is to report to Parliament on the operations of the Account to comply with the *Currency Act*. The reporting entity of the Account is limited to those transactions permitted by a policy established by the Minister of Finance. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada. These costs are not recognized in the financial statements.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Minister of Finance.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

All material changes in cash flows are evident from the financial statements. A separate statement of cash flows has not been prepared.

c) Use of estimates

The preparation of the financial statements of the Account requires management to make estimates and assumptions, based on information available as of the date of the financial statements. The most significant use of estimates is in the presentation of assets at fair value. Actual results could differ significantly from those estimates.

d) Translation of foreign currencies and Special Drawing Rights

Assets and advances denominated in foreign currencies and special drawing rights (SDRs) are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates, which were as follows:

	31 March 2006	31 December 2004
US dollars	1.1680	1.2020
Euros	1.4153	1.6287
Japanese yen	0.009923	0.011727
SDRs	1.68291	1.86050

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the fiscal year, are recorded as net foreign exchange gains or losses and are included in the category *Other revenue* in the *Statement of Revenue*.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) Revenue

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Interest is accrued on short-term deposits, deposits held under repurchase agreements, marketable securities, and special drawing rights. Accrued interest is recorded in the category *Other assets* on the *Balance sheet.*

f) Assets

Short-term deposits
Short-term deposits are money market transactions where the Account invests funds with designated counterparties. Short-term deposits are recorded at cost and are generally held to maturity.

Deposits held under repurchase agreements
Deposits held under repurchase agreements are money market transactions where the Account invests funds on a secured basis with designated counterparties at prevailing market rates based on tri-party reverse repurchase agreements. The collateral on these transactions is held by a tri-party custodian. Deposits held under repurchase agreements are recorded at the amount originally invested.

Marketable securities
Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums. Purchases and sales of securities are recorded at the settlement dates.

Write-downs to reflect other than temporary impairment in the fair value of securities are included in *Revenue from investments* in the *Statement of Revenue.*

Special Drawing Rights
The special drawing rights (SDR) serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. SDRs are recorded at fiscal year-end market value.

Gold
Gold is carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada.* The Account sold its remaining gold bullion in 2003 and continues to hold gold coins. Net gains on gold sales are recorded at settlement dates.

g) Securities Lending Program

The Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. The securities loaned continue to be accounted for as investment assets. Revenue from the securities-lending program is included in *Revenue from investments* in the *Statement of Revenue.*

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar or to meet net government requirements for foreign exchange. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 97 per cent (90 per cent as at 31 December 2004) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

4. Cash and Short-Term Deposits

	31 March 2006	31 December 2004
	Carrying value	Carrying value
US dollar	4,065	2,529
Euro	91	42
Japanese yen	83	97
	4,239	2,668

5. Deposits Held Under Repurchase Agreements

	31 March 2006	31 December 2004
	Carrying value	Carrying value
US dollar	2,278	–
	2,278	–

At 31 March 2006, the term to maturity of deposits held under repurchase agreements was less than 3 months.

6. Marketable Securities

Term to maturity

	31 March 2006									31 December 2004
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Carrying value
US dollar										
Sovereign	4,181	4.27%	147	3.72%	352	4.44%	1,572	4.28%	6,252	6,357
Supra National	1,820	4.11%	147	4.05%	1,032	4.49%	978	4.53%	3,977	2,709
Agencies and other	3,768	4.42%	210	4.34%	1,753	4.59%	1,382	4.70%	7,113	5,285
Carrying Value	9,769		504		3,137		3,932		17,342	14,351
Euro										
Sovereign	282	2.38%	163	3.97%	7,396	3.89%	2,420	3.44%	10,261	11,643
Supra National	–		–		716	4.61%	284	3.35%	1,000	989
Agencies and other	143	4.54%	75	2.64%	2,126	3.76%	1,412	3.70%	3,756	3,605
Carrying Value	425		238		10,238		4,116		15,017	16,237
Japanese Yen										
Sovereign	–		–		496	1.91%	–		496	1,173
Carrying Value	–		–		496		–		496	1,173
Total securities										
Carrying value	10,194		742		13,871		8,048		32,855	31,761

The yield in the above table represents the weighted average yield to maturity based on the carrying value at the end of the fiscal year for the respective securities.

The outstanding unamortized premium/discount on marketable securities amounts to $193 million ($230 million at 31 December 2004).

At 31 March 2006, a portion of the Account's holdings of US government securities, consisting of US$1,815 million (par value) in Treasury Bills (US$1,830 million at 31 December 2004) and US$1,130 million (par value) in Treasury Notes (US$1,165 million at 31 December 2004), is being used in securities-lending operations with financial institutions.

7. Accrued Interest and Other Receivables

	31 March 2006	31 December 2004
Accrued interest		
Cash and short-term deposits	12	4
Deposits held under repurchase agreements	9	–
Marketable securities		
US dollar	107	164
Euro	359	461
Japanese yen	–	4
SDRs	6	4
Other receivables	–	–
	493	637

The fair value of the accrued interest and other receivables is deemed equal to their carrying value given their maturity date.

8. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to $60 billion by order of the Minister of Finance dated 30 December 2005. At fiscal year-end, advances from (deposits with) the CRF consisted of:

	31 March 2006	31 December 2004
US dollars	24,698	20,332
Canadian dollars	349	(2,108)
Euros	14,606	16,027
Japanese yen	576	1,266
SDR	(1,027)	(1,135)
	39,202	34,382

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

9. Financial Instruments

a) Risk management

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the Account asset portfolio is prudently diversified with respect to credit risk, the policy and investment guidelines prescribed by the Minister of Finance specify limits on holdings by class of issuer (sovereign, agency, supranational, or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to policy and investment guidelines, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues must have a minimum long-term rating of A- or A3 from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service), one of which must be either Moody's or Standard & Poor's. The Account may also make deposits and execute other transactions with commercial financial institutions that meet the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to earn extra return on investments.

b) Interest rate and foreign currency risk

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the Account's assets with the related foreign currency borrowings of the Government of Canada.

c) Fair value of financial instruments

	31 March 2006		31 December 2004	
	Carrying value and accrued interest	Fair value	Carrying value and accrued interest	Fair value
Investments				
Cash and short-term deposits	4,251	4,251	2,672	2,672
Deposits held under repurchase agreements	2,287	2,287	–	–
Marketable securities				
US dollar	17,449	17,235	14,514	14,685
Euro	15,376	15,448	16,698	17,552
Japanese Yen	496	511	1,178	1,218
	39,859	39,732	35,062	36,127
SDRs	1,071	1,071	1,111	1,111
Gold	6	74	7	57

The estimated fair value of cash, short-term deposits, deposits held under repurchase agreements and SDRs is deemed equal to their carrying value given their maturity date.

Estimated fair values of marketable securities are based on quoted market prices. Prevailing market conditions at 31 March 2006 reduced fair values on US dollar marketable securities below carrying values. As it is uncertain that these conditions reflect other than temporary impairment in the fair value, these securities have not been written-down to fair value.

The estimated fair value of gold is based on London fixing of $679.78 ($526.48 at 31 December 2004) per fine ounce.

10. Commitments

a) Currency swaps

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility during the 15 month period ended 31 March 2006 or during the year ended 31 December 2004, and there were no commitments outstanding as at 31 March 2006.

b) Foreign currency contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 March 2006, the Account was under contract to sell $25 million ($8 thousand at 31 December 2004) of foreign currency. Unrealized gains (losses) are calculated using the 31 March 2006 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 December 2004). Outstanding foreign currency contracts were settled by 3 April 2006.

c) Investment contracts

In the normal course of operations, the Account enters into investment contracts. The following table presents the fair value of investment contracts with contractual amounts outstanding at 31 March 2006. Outstanding investment contracts were settled by 6 April 2006.

	31 March 2006		31 December 2004	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US dollar				
Purchases	(663)	(663)	–	–
Sales	82	82	–	–
Euro				
Purchases	(94)	(94)	–	–
Sales	93	93	–	–

11. Comparative Figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.

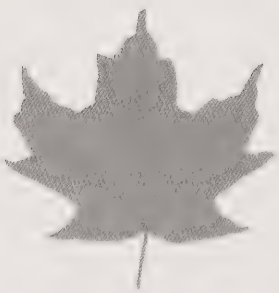
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Report on the Management of Canada's Official International Reserves

April 1, 2006 – March 31, 2007



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Report on the Management of Canada's Official International Reserves

April 1, 2006 – March 31, 2007



Department of Finance Canada
Ministère des Finances Canada

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Purpose of the Report

This edition of the *Report on the Management of Canada's Official International Reserves* provides details on official international reserves operations, primarily the management of the Exchange Fund Account (EFA), from April 1, 2006 to March 31, 2007.

On a market-value basis, the official international reserves stood at US$39,309 million as of March 31, 2007 (Table 1), including the International Monetary Fund (IMF) reserve position, which is Canada's investment in the activities of the IMF. The IMF reserve position, which is not actively managed, fluctuates according to drawdowns and repayments from the IMF. Special drawing rights (SDRs), which are international reserve assets created by the IMF based on a basket of international currencies, and gold are also not actively managed.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets. The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currency. Assets and liabilities are matched as closely as possible in currency and duration to minimize exposure to currency and interest rate risks.

This report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the position of the EFA asset portfolio as of fiscal year end.

Table 1

The EFA and Official International Reserves

	March 31, 2007	March 31, 2006	Change
	(market value in millions of US dollars)		
Securities	33,657	28,420	5,237
Deposits	3,882	5,596	-1,714
Total securities and deposits (liquid reserves)	37,539	34,016	3,523
Gold	72	63	9
Special drawing rights (SDRs)	976	917	59
Total EFA	38,587	34,996	3,591
IMF reserve position	722	1,038	-316
Total official international reserves	39,309	36,034	3,275

Highlights

Portfolio Management

- **Change in the level of the official international reserves:** The market value of the official international reserves increased to US$39.3 billion as of March 31, 2007 from US$36.0 billion as of March 31, 2006. The change comprised a US$3.6-billion increase in EFA assets and a US$0.3-billion decrease in the IMF reserve position.
- **EFA funding sources:** The program of cross-currency swaps of domestic obligations was the primary source of foreign currency funding for the EFA. US$5 billion was raised at an average cost of 3-month US$ LIBOR (London Inter-Bank Offered Rate) less 41 basis points, a funding cost better than was obtained in recent years.

Performance and Risk Measurement

- **Asset-liability portfolio performance:** The EFA is a stand-alone asset portfolio within the Public Accounts framework and is audited on this basis. It is managed against a portfolio of Government of Canada foreign currency liabilities in order to provide transparency on the net return to the Government and to minimize risk.

  From April 1, 2006 to March 31, 2007, on a mark-to-market or total return basis, including net interest income and all gains or losses earned over the period and the cost of funds, the net total return was a gain of US$105 million, or +31 basis points.

  Although the portfolio returned an underlying profit on a market-value basis, on a book-value basis, the Government experienced net losses. This is captured in the carry measure, which reports the performance of the asset-liability portfolio from a cash flow perspective. Of note, the carry measure is indicative of the impact of the performance of the reserves on the *Public Accounts of Canada*, which are also measured on a book-value basis. For 2006–07, the carry of the portfolio was a loss of US$110 million, or -32 basis points. This amount includes US$77.7 million in realized losses on US-dollar and euro asset sales, as well as net interest costs of US$32 million. The difference between the market or total return measure and the book or carry measure is due to the fact that the total return measure includes both realized and unrealized gains and losses while the carry measure includes only realized gains or losses. During the reporting period unrealized gains more than offset realized losses.
- **Asset-liability portfolio risk:** Market risk measures, such as Value-at-Risk, and various stress tests indicate the EFA portfolio was at all times well positioned to cope with adverse movements in interest and exchange rates. Also, various credit risk measures show that the EFA portfolio is well positioned in terms of its credit risk exposure.

Portfolio Assessment

- **Current practices and management:** An external evaluation of the management of the EFA was conducted as part of the Government's Treasury Evaluation Program. The evaluation, conducted by Fischer Francis Trees & Watts, concluded that the EFA is being managed prudently, effectively and with due regard for its strategic objectives.
- **Suggested recommendations for enhancement of returns:** The recommendations of the external evaluation focused on enhancing portfolio returns at the expense of liquidity. The recommendations of the report will be considered at a later date, given the Government's current desire to maintain a very high standard of liquidity for its reserves portfolio and to mitigate market risk to the greatest extent possible.

Overview of the Exchange Fund Account Management Framework

This section describes the EFA management framework, including the objectives and principles and governance structure. It also summarizes policies governing investment, risk management and performance measurement.

Objectives and Principles

Objective

- The objective of the EFA is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required.

Strategic Objectives

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

Overarching Funds Management Principles

- **Efficiency and effectiveness:** Policy development and operations should take into account, to the extent possible, leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework and borrowing and investing programs.
- **Transparency and accountability:** Information on financial asset and liability management plans, activities and outcomes should be made publicly available in a timely manner. Information on borrowing costs, investment performance and material exposures to financial risk should be measured, monitored, controlled and regularly reported as applicable.
- **Risk management:** Risk monitoring and oversight should be independent of financial asset and liability management operations.

Reserves Management Principles

- **Prudence:** The foreign reserves should be managed to limit exposure to financial risk through the matching of foreign-currency-denominated assets and liabilities, the adherence to prudent investment limits, and the diversification in instruments, currencies and maturities held.
- **Cost-effectiveness:** The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.

Governance of the EFA

The *Currency Act*

The EFA is governed by the provisions of the *Currency Act*, which allows the Minister of Finance to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy*.

Statement of Investment Policy

A *Statement of Investment Policy* (SIP) was approved by the Minister in September 2006. The SIP sets out the policy governing the acquisition, management and divestiture of assets for the EFA and details the investment objectives, eligible asset classes and currencies, and risk exposure limits. The policies are designed to ensure prudent and effective management practices are followed in accordance with reserves management objectives and principles. The SIP is provided in Annex 1.

Governance Structure

Responsibility for the management of the EFA is shared between the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account. The strategic planning and the operational management of the EFA are conducted jointly by the two organizations.

The Funds Management Committee (FMC), composed of senior management from the Department of Finance and the Bank of Canada, oversees the management of the EFA and is a decision-making body within limits delegated by the Minister. The Committee advises the Minister on policy and strategy, oversees the implementation of approved policy and plans, reviews performance outcome reports and makes decisions related to the management of the reserves.

The FMC is supported by a Risk Committee (RC), whose mandate is to review and provide opinions on the risk implications of policy proposals and recommendations. The Financial Risk Office at the Bank of Canada provides analytical support to the RC and is responsible for monitoring and regularly reporting on the EFA's financial performance and its exposure to credit, liquidity, market and operational risks.

The FMC is also supported by the Asset Liability Management Committee (ALMC), which provides recommendations to the FMC, in its advisory role, on strategic and policy matters affecting the management of foreign reserves, including changes to the limits and guidelines pertaining to the foreign reserves established by the Minister of Finance and the FMC. Within limits delegated by the FMC, the ALMC is also a decision-making body, whose decisions are executed by officials at the Bank of Canada and the Department of Finance.

For more information on the governance framework of the EFA, please consult the document entitled *Funds Management Governance Framework* at www.fin.gc.ca/treas/Goveev/TMGF_e.html.

EFA Management Policy

Management of the EFA follows a set of policies that apply to investment, asset-liability management, risk management and performance measurement.

Investment Policy

The policy governing the management of assets, set out in the SIP, is designed to achieve the strategic objectives of maintaining a high standard of liquidity, preserving capital value and, subject to those constraints, maximizing return. To achieve these goals, the policy permits a range of investments, notably in US-dollar-, euro- and yen-denominated securities (bonds and bills) issued by sovereigns and their agencies or supranational organizations. The policy also permits investment in cash deposits with financial institutions, US-dollar tri-party repurchase agreements (repos), commercial paper and certificates of deposit issued by private sector entities, gold and IMF special drawing rights. Lastly, the SIP allows for securities-lending activities to generate incremental returns.

Eligibility for investment in the EFA is based on a prudent framework that incorporates external credit ratings. To be eligible for investment, an entity must have a credit rating in the top seven categories from at least two of four rating agencies: Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. The only allowable unrated investments are the following: securities issued by and deposits with central banks and the Bank for International Settlements and investments in special drawing rights created by the IMF. Beyond credit ratings, the SIP also sets limits pertaining to issuers and counterparties across all lines of business and defines high liquidity standards of reserve asset classes.

The investment policy splits investments for the EFA into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the core liquidity requirements in foreign currencies and consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

Asset-Liability Management Policy

Foreign currency reserve assets held in the EFA and the Government of Canada foreign currency liabilities and swaps that notionally finance those assets are managed on a portfolio basis, and are matched as closely as possible in currency and duration, so that the net exposure to currency and interest rate risks is limited. The policy seeks to minimize the gap between the market value of assets and liabilities, as monitored on a daily basis, to within a target range of +/-US$300 million.

Risk Management Policy

Risk management policy requires identifying, monitoring, mitigating, to the extent required, and the regular and timely reporting of treasury risk exposures. Treasury risk includes credit, liquidity, legal, market and operational risks related to the financing and investment of the foreign exchange reserves. For more information, see the box entitled "Risk Management Policy Developments" later in this section.

Performance Measurement Policy

Performance measurement policy provides a framework for measuring, analyzing and evaluating the financial performance of EFA investments and associated liabilities. The policy requires regular and timely reporting to senior management within the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament of the returns on EFA assets and the cost of associated liabilities.

The principal measures are based on accounting book-based information (revenues and the net carry measure), as well as an economic market-based measure of asset-liability performance called total return. In addition to economic market-based measures, liability benchmarks, external indices and attribution analysis are also used to measure portfolio performance. For more information on the performance measures, please see the "Portfolio Performance Measurement" section later in this document.

Asset-liability performance is reported monthly to management at the Department of Finance and the Bank of Canada, periodically to the Minister of Finance and annually to Parliament. As required by the *Currency Act*, the Office of the Auditor General of Canada audits the financial statements of the EFA and reports to the Minister annually on a fiscal-year basis.

Major Initiatives in 2006–07

During 2006–07, major initiatives focused on implementing a new investment regime as per the EFA's SIP, strengthening the funds management governance and risk management frameworks, and evaluating the effectiveness of the management of the EFA.

Implementation of the New Investment Regime

As required by the *Currency Act*, the SIP governs the acquisition, management and divestiture of assets for the EFA. The SIP allows for the investment in two new short-term asset classes: commercial paper and certificates of deposit. Investment in these new asset classes began in 2006–07.

Commercial paper is a marketable senior level unsecured short-term instrument, typically issued by the largest and most creditworthy issuers as an alternative to bank loans. Only traditional commercial paper issued and fully backed by top-rated financial institutions and financial affiliates of commercial firms is eligible for investment in the EFA. Of note, asset-backed commercial paper does not qualify. As described in the SIP, the amount of funds that may be invested in commercial paper varies according to the credit quality of the issuer. As an example, the maximum amount that may be invested in commercial paper issued by an entity with the highest credit rating is US$300 million. Further, there is also an aggregate limit on the total amount of commercial paper that may be held within the EFA. Certificates of deposit are marketable deposits issued by banks as an alternative to term deposits.

Investment in commercial paper and certificates of deposit were approved as eligible asset classes for the EFA as their inclusion improves the overall liquidity and investment performance of the EFA with minimal additional risk. Limits as to eligible issuers and the amounts that may be invested are specified in the SIP.

Strengthening of the *Funds Management Governance Framework*

The *Funds Management Governance Framework*, which sets out the decision-making authority for the EFA and ensures accountability through appropriate performance measurement, risk management and reporting, was enhanced to focus the roles, responsibilities and accountability for the management of the EFA. For example, the purpose and role of the Funds Management Committee (FMC), the most senior committee, have been clarified to better reflect its responsibilities and those that it has delegated to subordinate committees. The purpose and responsibilities of the Risk Committee have also been refined to better reflect its relationship with the FMC and coordinating committees. As well, an Asset Liability Management Committee (ALMC) has been incorporated within the governance framework to provide recommendations to the FMC, in its advisory role, on strategic and policy matters affecting the management of the EFA, including changes to the pertinent limits and guidelines. The ALMC is also a decision-making body, within limits delegated by the FMC, whose decisions are executed by officials at the Bank of Canada and the Department of Finance.

Strengthening of the Risk Management Framework

An effective risk management framework requires identifying, measuring, monitoring and managing risks related to the financing and investment of the foreign reserves. It also includes regular and timely reporting of risk exposures. As such, new risk measures and reporting practices were developed to enhance the monitoring and reporting of operational and liquidity risks.

The new operational risk measures and reporting framework provide management with a better understanding of the nature, frequency and severity of operational risks that arise from time to time in the management of the EFA. For instance, the new measures classify each operational risk event according to the risk drivers and resultant consequences. The risk drivers are further classified according to the relevant source, which may involve people, processes, systems or external factors. The consequences of operational risk events are also further classified according to limit breaches, business delays and monitoring/reporting issues. For both the risk drivers and consequences, each event is also classified according to severity using a standardized scale. In terms of monitoring and reporting, monitoring of operational risk events occurs on a real-time basis with formal reports being produced for management at least semi-annually.

The new liquidity stress test measures provide an indication of the EFA's ability to meet commitments as they become due under various market conditions. The latter include circumstances wherein the markets are functioning normally, conditions in which the markets are moderately disrupted and conditions in which the EFA is also being used to support intervention in foreign exchange markets. These measures provide a better understanding of how well the EFA is achieving the key strategic objective of preserving liquidity.

Evaluation of the Management of the EFA

As a component of ongoing reviews that are part of the Treasury Evaluation Program, an external evaluation of the EFA was completed in 2006–07. The evaluation was undertaken to assess the effectiveness of current practices in achieving the objectives of the EFA, as well as seeking recommendations to further enhance the management of the EFA.

The evaluation focused on the EFA portfolio structure, investment guidelines, asset eligibility, performance measurement metrics and reporting. The evaluation process involved a comparison of the EFA's investment framework with the general investment practices of similar large, public sector institutional investors. The evaluation concluded that Canada's investment policies and practices compare well to the practices of other comparable countries and that the EFA is being managed prudently, effectively and with due regard for the three key objectives: liquidity, capital preservation and return enhancement.

The evaluation also suggested that the EFA is managed relatively conservatively and provided recommendations on ways in which the EFA's investment returns could be enhanced. The latter focused on two areas: seeking additional returns by investing in less liquid assets and by adding market risk. Examples of areas identified for consideration include re-evaluating eligible currencies and their allocations, broadening the list of eligible investments and allowing unmatched interest exposure between the EFA's assets and corresponding liabilities. These recommendations will be considered at a later date. For more information on the evaluation of the EFA, please visit www.fin.gc.ca/efa/EFA2006_e.pdf.

Risk Management Policy Developments

The EFA's exposure to market risk is mitigated by matching the financial characteristics of the assets and liabilities of the EFA. A Value-at-Risk (VaR) model and various stress tests that are considered to be industry standards are employed to measure the EFA's exposure to market risk. VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from normal market movements such as changes in interest and exchange rates, while stress tests are used to evaluate the portfolio's performance under extraordinary circumstances in the market.

Credit risk, which is the most important risk faced by the EFA, is controlled by setting limits on both actual and potential exposures to counterparties. A collateral management framework is used for managing the credit risk to financial institution counterparties arising from the cross-currency swaps used to fund the EFA. Under these frameworks, high quality collateral is placed with collateral managers for the EFA when the market value of the swap contracts exceeds specified limits. Along with liquidity and legal risks, credit risk is also controlled through strict guidelines.

Lastly, operational risk is managed by the Bank of Canada and is monitored and reported on a regular basis.

Risk policy issues are reviewed on an ongoing basis, with the current focus in various key areas:

Credit Risk:

The main objective of credit risk policies of the Government is to distribute credit exposures to counterparties in a manner that provides effective control over the Government's exposure to counterparty risk. These policies include guidelines for assessing counterparty credit quality, setting exposure limits to those counterparties and measuring, monitoring and reporting credit exposures.

Credit ratings from four credit rating agencies are used to derive an internal rating to establish the credit quality of each counterparty. This enables the Government to rank counterparties in a transparent manner, with higher-rated counterparties receiving larger exposure limits than those that have lower credit ratings. The methodologies used by rating agencies are monitored on a regular basis to ensure they meet the needs of the Government.

Review of the *Treasury Risk Management Framework*:

The *Treasury Risk Management Framework* is undergoing an external review in 2007–08 to ensure its appropriateness with ongoing risk management developments. The evaluation will consider the effectiveness of the current risk management framework in controlling the risks that have been identified as well as the comprehensiveness and completeness of the framework in identifying, measuring, controlling and reporting on the full range of pertinent risks.

Report on Operations in 2006–07

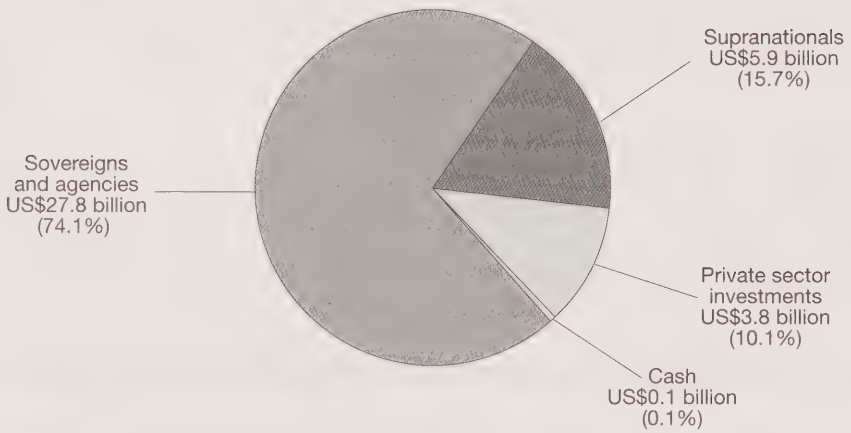
This section reviews operations related to the official international reserves, including the achievement of objectives, changes in the level of reserves, portfolio performance and risk measurements.

Performance Versus Strategic Objectives

The *Currency Act* stipulates that this report provide a statement of whether the strategic objectives have been met during the review period. The three objectives, which are to maintain a high standard of liquidity, preserve capital value and optimize return, have been achieved, as the level of liquidity was maintained for the reserves portfolio throughout the reporting period, and the portfolio's exposure to market and credit risks remained stable (see the section entitled "Risk Measures"). In addition, the total return measure was positive (see the section entitled "Portfolio Performance Measurement").

In practice, the EFA portfolio is mainly invested in sovereign and government-sponsored entity securities (74 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).[1] The share of deposits and repos is small because they offer lower liquidity than other investment options. The Liquidity Tier mainly consists of US Treasury securities, given that they are the most liquid securities in the market.

Chart 1
Composition of EFA Liquid Investments as at March 31, 2007
(market value)

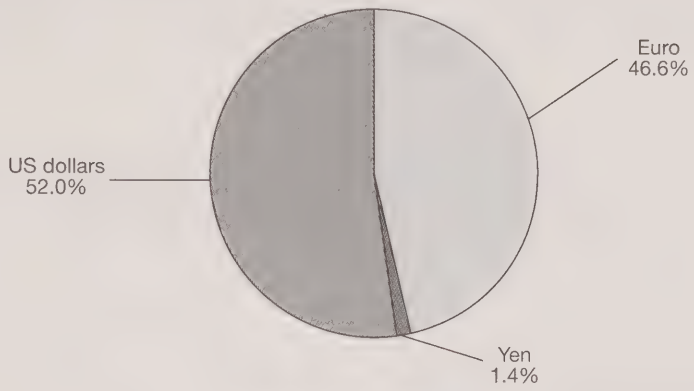


The current practice is to hold a significant portion of the reserves in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange intervention has mainly consisted of transactions involving the US dollar. As at March 31, 2007, the US-dollar share of the EFA liquid investments was US$19.5 billion or 52 per cent, the euro share was 13.1 billion euros or 46.6 per cent, and the yen portion was 59.5 billion yen or 1.4 per cent (Chart 2).[2]

[1] Excludes gold and SDR holdings.

[2] Excludes gold and SDR holdings.

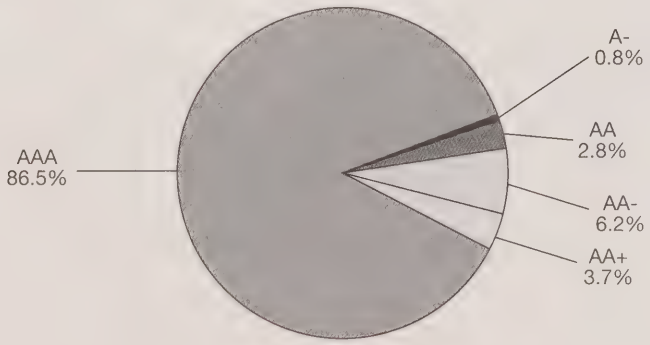
Chart 2
Currency Composition of EFA Liquid Investments as at March 31, 2007
(market value)



To help achieve the objective of preserving capital value, an entity must have a credit rating of at least A-/A3 to be eligible for investment in the EFA, as according to the SIP. The majority of EFA investments are in the AAA category, as indicated in Chart 3.[3] Of note, repurchase agreements are included and secured by AAA/Aaa securities.

Counterparty limits are established based on a framework that incorporates external ratings from credit rating agencies, and compliance with counterparty limits is monitored on a real-time basis.

Chart 3
Official Liquid Reserves as at March 31, 2007
(settled basis)



[3] Excludes gold and SDR holdings.

Market Developments During the Reporting Period

The official international reserves are reported on a market-value basis and in US dollars, meaning that changes in interest and exchange rates will affect the market value of the reserves. Overall, changes in exchange rates increased the value of the reserves by US$1.6 billion and changes in interest rates increased the value of the reserves by US$192 million.

Interest Rates

As examples of changes over 2006–07, the yield on US 3-month Treasury bills increased by 35 basis points while the yield on US 5-year Treasury bonds decreased by 31 basis points (Chart 4). The changes in interest rates had the effect of slightly increasing the market value of the EFA's assets.

Chart 4
The Evolution of US 3-month and 5-year Treasury Yields From March 31, 2006 to March 31, 2007



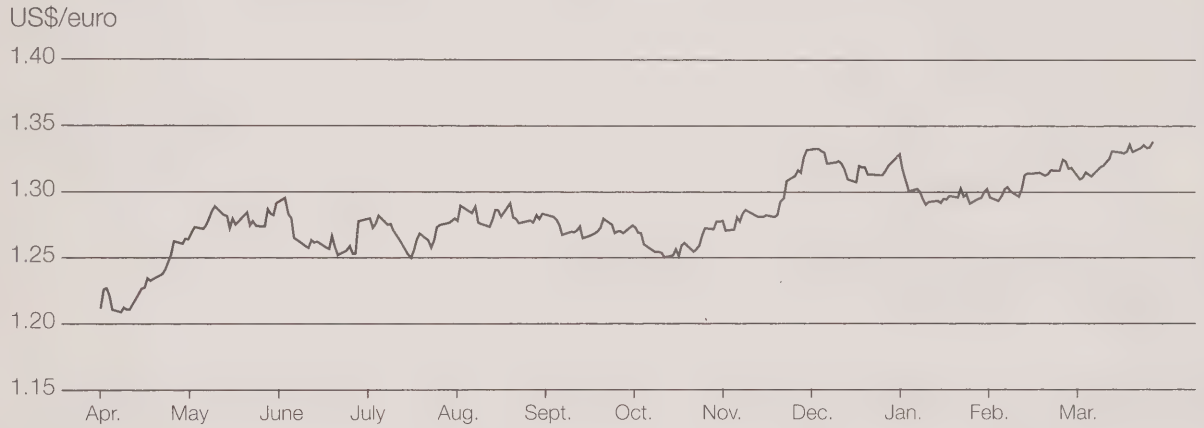
Since the EFA is managed according to an asset-liability matching framework, both the reserves and its associated liabilities increased in similar magnitude. In turn, these effects necessitated modest alterations to the annual funding projections in order to maintain the reserves at close to their target level. As well, the rising short-term US interest rate environment decreased the EFA's funding costs, as the Government was required to pay lower floating interest payments while maintaining fixed interest receipts to match the fixed interest payments on domestic bonds on its cross-currency swaps.

The euro-denominated holdings within the reserves are mainly composed of longer-term issues. As the changes in European longer-term interest rates over 2006–07 were relatively minor, with an increase of only 3 basis points, the impact on the reserves was small.

Exchange Rates

As roughly 47 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2007), the market value of the reserves was significantly affected by movements in the euro. From March 31, 2006 to March 31, 2007, the euro appreciated 10.3 per cent against the US dollar. The highest level of the US dollar/euro exchange rate during the period was 1.3373 on March 30, 2007, while the low was 1.209 on April 10, 2006 (Chart 5).

Chart 5
The Evolution of the Euro from March 31, 2006 to March 31, 2007

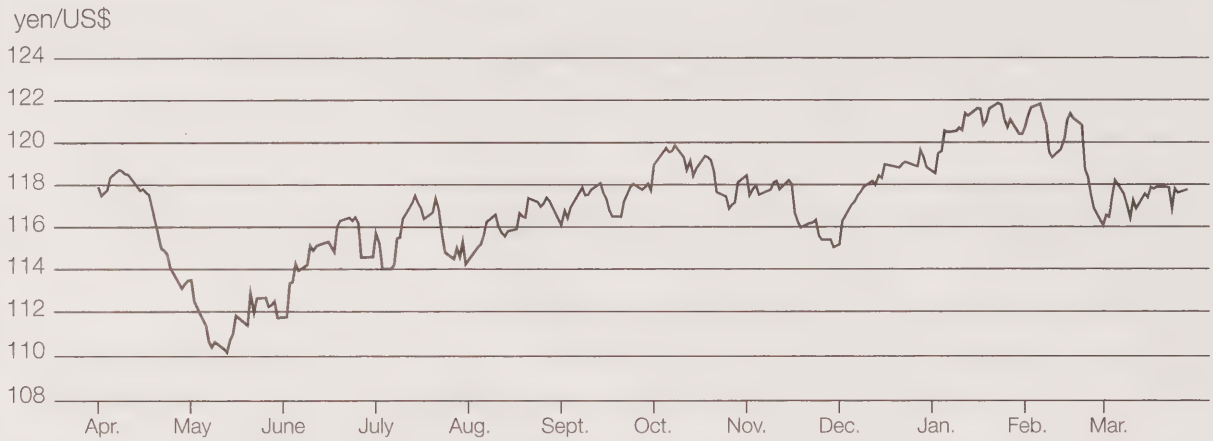


As with changing interest rates, the appreciation of the euro affected the annual funding requirements by increasing the market value of the reserves, measured in dollars, thereby decreasing the annual funding requirements needed to maintain the reserves at close to their target level.

The level of the official international reserves was less exposed to changes in the yen/US-dollar exchange rate (Chart 6) since only 1.4 per cent of the reserves were held in yen-denominated assets (as at March 31, 2007). Overall, the yen appreciated by 0.1 per cent against the US dollar during the reporting period. The highest level of the yen/US dollar exchange rate during the period was 110.202 on May 16, 2006, and the low was 121.81 on January 29, 2007.

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the value of the investments held in the reserves. Over the period from March 31, 2006 to March 31, 2007, movements in interest rates had a smaller effect on the reserves than movements in exchange rates: changes in interest rates increased the market value of the reserves by US$192 million, while foreign currency revaluations increased their market value by US$1.625 billion.

Chart 6
The Evolution of the Yen from March 31, 2006 to March 31, 2007



Composition of the Official International Reserves as at March 31, 2007

Table 2 shows the distribution of investments in the official international reserves by currency and term to maturity as at March 31, 2007. US-dollar holdings, which made up more than half of the reserves, were primarily in short-term (i.e. under six months) maturities, as they are held for liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards medium-term (i.e. one to five years) investments. Likewise, the yen holdings were mostly invested in securities with medium-term maturities.

For reporting purposes, gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars. The IMF reserve position is classified as an investment of indefinite term.

IMF Reserve Position

The International Monetary Fund (IMF) is an international organization that is structured as a financial cooperative owned by its member nations whose objective is to promote international monetary cooperation and exchange stability and to help foster economic growth. One of the functions of the IMF is to provide financial assistance to countries experiencing temporary balance of payment difficulties. The IMF also promotes economic growth and poverty reduction by providing loans to countries in need at favourable rates.

Each country (including Canada) that joins the IMF is assigned a quota that represents the maximum amount of resources that a country is obliged to provide to the IMF, upon request. As well, the IMF typically has on deposit with each respective government holdings in the form of non-interest-bearing notes and non-interest-bearing accounts. Canada's reserve position at the IMF represents the difference between Canada's quota and the IMF's holdings of Canadian dollars, which is equivalent to the cumulative amount of all the money that Canada has advanced to the IMF over the years.

Canada's IMF reserve position is an asset that is included as a component of the official international reserves. As such, changes in Canada's IMF reserve position that may result from advances, repayments or revaluations directly impact the Government of Canada's Public Accounts. However, because the IMF reserve position is not actively managed by the Department of Finance or the Bank of Canada, it is not included in the EFA and is instead represented within the wider category of official international reserves. Further, in order to reconcile the holding of the IMF reserve position within the official international reserve's asset-liability matching framework, only US-dollar liabilities are deemed to fund the reserve position.

Table 2

Term Structure of the Official International Reserves as at March 31, 2007

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Total official international reserves
				(market value in millions of US dollars)				
US-dollar holdings								
Under 6 months	3,555	3,635	5,657	–	–	**12,847**	–	**12,847**
6 to 12 months	–	–	335	–	–	**335**	–	**335**
1 to 5 years	–	–	3,135	–	–	**3,135**	–	**3,135**
Over 5 years	–	378	2,854	–	–	**3,232**	–	**3,232**
Indefinite term	–	–	–	72	976	**1,048**	722	**1,770**
Total US-dollar holdings	3,555	4,013	11,981	72	976	**20,597**	722	**21,319**
Euro holdings[1]								
Under 6 months	257	264	311	–	–	**832**	–	**832**
6 to 12 months	–	106	334	–	–	**440**	–	**440**
1 to 5 years	–	8,276	2,218	–	–	**10,494**	–	**10,494**
Over 5 years	–	4,343	1,377	–	–	**5,720**	–	**5,720**
Total euro holdings	257	12,989	4,240	0	0	**17,486**	0	**17,486**
Yen holdings[1]								
Under 6 months	71	–	–	–	–	**71**	–	**71**
6 to 12 months	–	–	–	–	–	–	–	–
1 to 5 years	–	434	–	–	–	**434**	–	**434**
Over 5 years	–	–	–	–	–	–	–	–
Total yen holdings	71	434	0	0	0	**505**	0	**505**
Total	3,882	17,435	16,222	72	976	**38,587**	722	**39,309**

[1] The exchange rates prevailing on March 31, 2007, are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

The level of the official international reserves changes over time due to a variety of factors. As shown in Table 3, over the 12-month reporting period the level of the reserves increased by US$3.3 billion due to reserves management operations (US$1.6 billion), return on investments (US$1.4 billion) and revaluation effects (US$1.6 billion). The increase was partly offset by foreign currency debt charges (US$1.4 billion).

Table 3

Sources of Changes in Canada's Official International Reserves (March 31, 2006 to March 31, 2007)

	Change
	(market value in millions of US dollars)
Official intervention	–
Net government operations	–
Reserves management operations	1,631
Gains and losses on gold sales	–
Return on investments	1,392
Foreign currency debt charges	-1,373
Revaluation effects	1,625
Other	-1
Total change	3,275

Note: Numbers may not add due to rounding.

Official Intervention

Official intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and would therefore affect the level of the official international reserves. Intervention in the Canadian-dollar foreign exchange market has not occurred since 1998 (see Annex 2).[4]

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements will affect the official international reserves. There were no net government operations during the reporting period.

Reserves Management Operations

Matched debt issues/maturities and purchases/sales of foreign currency assets affect the level of the EFA. Over the reporting period, funds raised through the issuance of cross-currency swaps and Canada bills, totalling US$17 billion, more than offset debt maturities (US$15 billion in total, including a US$1-billion global bond, Canada bill maturities totalling US$12 billion and cross-currency swap maturities of US$2 billion), resulting in a net increase in the level of official international reserves.

[4] Since that time, the only market intervention was the purchase of euros in 2000 as part of Canada's participation in concerted Group of Seven (G7) intervention in support of the euro.

Gains and Losses on Gold Sales

This factor reflects the difference between the value of gold holdings at the beginning and the end of the reporting period due to gold sales and a change in the market value of gold. There were no gold transactions during the period, with the last of the Government's gold bullion holdings having been sold in December 2003.

Return on Investments

Return on investments comprises interest earned on investments (US$1.2 billion) and the increase in the market value of securities resulting from changes in interest rates (US$192 million). The overall effect on the official international reserves was a net increase of US$1.4 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by US$1.4 billion.

Revaluation Effects

Revaluation effects resulting from movements in exchange rates reflect changes in the market value of the official international reserves. Revaluation effects increased the official international reserves by US$1.6 billion, primarily due to the appreciation of the euro versus the US dollar.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Annex 3.

EFA Financing

As previously noted, the assets in the EFA are managed against a portfolio of dedicated liabilities. The liabilities are Government of Canada foreign currency borrowings from a variety of sources (Table 4).

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap issuance and maturities during the reporting period were US$5 billion and US$2 billion, respectively. In recent years, swaps have been particularly cost-effective compared to other sources of foreign currency funds. During 2006–07, foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 41 basis points on average. This funding cost compares favourably with the rates obtained during the previous reporting period, which averaged 3-month US$ LIBOR less 35 basis points.

In addition to cross-currency swaps of domestic obligations, the EFA is funded by a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and euro medium-term notes [EMTNs]) and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From March 31, 2006 to March 31, 2007, the level of outstanding Canada bills decreased by US$2.5 billion. Canada bills were issued, on average, at an all-in cost of US$ LIBOR less 20 basis points, which was generally in line with funding levels of prior years. There was no new issuance of Canada notes, euro medium-term notes or global bonds during the period. One US-dollar global bond (US$1 billion) matured.

The changes in the outstanding numbers shown in Table 4 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars). Outstanding foreign currency issues are represented in Chart 7.

Further information on the management of foreign currency liabilities and the associated credit risks can be found in the *Debt Management Report* at www.fin.gc.ca/purl/dmr-e.html.

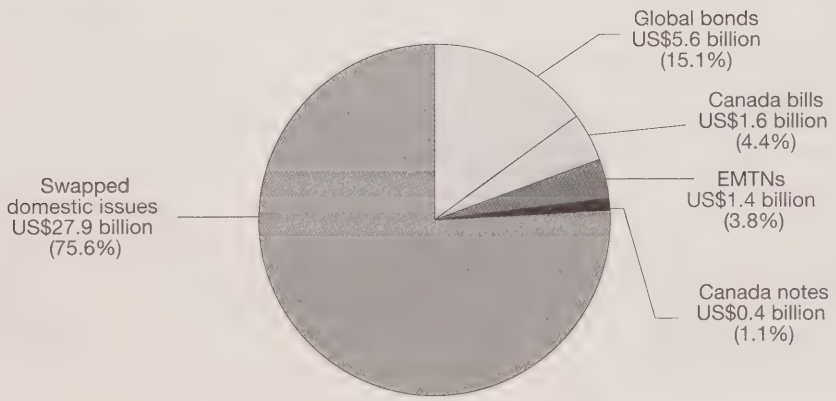
Table 4

Outstanding Foreign Currency Issues as at March 31, 2007

	March 31, 2007	March 31, 2006	Change
		(par value[1] in millions of US dollars)	
Swapped domestic issues	27,962	22,083	5,879
Global bonds	5,589	6,286	-697
Canada bills	1,600	4,053	-2,453
Euro medium-term notes	1,408	1,284	124
Canada notes	424	425	-1
Total	36,983	34,131	2,852

[1] Liabilities are stated at the exchange rates on March 31, 2007.

Chart 7
Outstanding Foreign Currency Issues as at March 31, 2007
(par value)



Portfolio Performance Measurement

Performance measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada.

Revenues

The revenues of the official international reserves include income from investments and foreign exchange gains. During the reporting period, income totalled C$1.77 billion, compared to C$1.73 billion in the previous reporting period. The main categories of income are summarized in Table 5. Data is reported in Canadian dollars, as EFA revenues, which account for the bulk of the revenues of the official international reserves, are reported in Canadian dollars in the attached financial statements.

Table 5

Revenues for the Official International Reserves as at March 31, 2007

	Official international reserves	
	Total revenue from April 1, 2006 to March 31, 2007	Total revenue from January 1, 2005 to March 31, 2006
	(millions of Canadian dollars)	
Investment income		
Marketable securities	1,368	1,840
Cash and short-term deposits	109	104
Deposits held under repurchase agreements	105	46
Special drawing rights	42	37
Total investment income	1,624	2,027
Other income		
Foreign exchange gains or losses	141	-293
Total income	1,765	1,734

The EFA's securities-lending program enhances the income earned on the portfolio by lending out securities that are highly sought after in the market. Income from securities lending, included in investment income from marketable securities in Table 5, totalled C$3 million during the period compared to C$8 million in 2006.

EFA Performance Measures

The performance of the EFA is reported using two separate measures. The first is called "carry" and represents the net revenue generated by the EFA's assets and corresponding liabilities from a cash-only perspective. For instance, carry represents the interest received on the EFA's assets minus the interest paid on the liabilities that fund the assets. The carry measure is also reported including any realized gains or losses stemming from asset sales, which is the difference between the amount for which an asset is sold compared to the amount it originally cost. A principal reason for using this measure of performance is that it depicts the effect of the EFA's net revenue on the *Public Accounts of Canada*, which currently account for financial assets and liabilities on an accrual basis.

The second measure of performance is called "total return." It represents the net return generated by the EFA by including the cash flows as depicted in the carry measure (i.e. interest streams and realized gains or losses), as well as the changes in the market values of the assets and liabilities over the reporting period. By including the market values of the EFA's assets and corresponding liabilities, the total return measure includes unrealized gains or losses, which is the difference between what an asset (or liability) is worth compared to what it cost. In this way, the total return measure depicts the market or fair value of the EFA.

The total return measure is used in several different ways. For instance, it is used to compare the performance of the EFA's assets to its liabilities in order to depict the net return of the portfolio on a market-value basis. The total return of the assets is also compared to an external liability index in order to provide an independent measure of the performance of the EFA and to enhance the understanding of performance in relation to broader market developments. Lastly, the EFA's total return is decomposed into the key sources of return. This is done by decomposing the total return measures for both the assets and liabilities into key sources of return through a technique called "performance attribution." This allows management to discern what aspects of total return resulted from controllable influences as compared to those sources that are market-driven. As well, the attribution analysis provides an indication as to how well objectives required by the asset-liability management framework of the EFA are being met.

Of the key sources of return, the coupon effect (what would have been earned had interest rates remained unchanged over the period) is the main driver of the EFA's positive total return. This is because the EFA's assets generate more interest income than what is required to pay for the EFA's liabilities. The yield curve effect (the impact of changes in the general level of interest rates) demonstrates the extent to which the EFA's assets and liabilities are matched in terms of their sensitivity to changes in interest rates. The spread effect (returns due to movements in interest rate spreads) illustrates how the EFA's assets and liabilities respond to changing interest rate spreads. Typically, movements in interest rate spreads will differ for assets according to their credit quality. As well, a component of the total return is generated through securities-lending activities. Any difference between the actual return and the sum of the above effects is called the "residual return," which is the unexplained portion of total return. By using these key sources of return, a clearer picture emerges as to the drivers of the EFA's annual total return.

Carry

Table 6 provides an estimate of the carry for the EFA and its constituent currency portfolios. The carry for the 2006–07 fiscal year was estimated at -9 basis points, an improvement over the previous period. The continued negative performance was due to the holding of low-coupon assets relative to the interest paid on older liabilities while this year's improvement was caused by a narrowing of the difference between the interest receipt and payment flows.

Taking into account gains or losses on asset sales recorded during the same period, the EFA accumulated net losses of US$110 million, or -32 basis points. This reflects US$78 million in net realized losses on US-dollar and euro asset sales plus net interest costs of US$32 million. Realized losses were significant due to sales of lower-coupon assets in favour of higher-yielding ones in an environment where interest rates have generally increased since the assets were originally purchased. Regardless of whether capital gains or losses are recorded on these transactions in an accounting sense in the year in which they took place, the EFA benefits in economic terms over the whole period during which the assets are held because it earns more interest income over the remaining life of the new higher-yielding investments than it would have done on the assets sold.

Table 6

Carry for the Official International Reserves[1]

	January 1, 2005 to March 31, 2006		April 1, 2006 to March 31, 2007				
	Carry	Carry (including net realized gains)	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry	Carry (including net realized gains)
	(basis points)		(millions of US dollars)			(basis points)	
Euro portfolio	-29	41.6	602.0	661.0	-59	-17.1	-17.3
Yen portfolio	0	0	8.1	8.0	0.1	0.1	0.1
US$ portfolio	-20.1	-17.1	856.5	829.5	27	7.8	-14.4
Total carry[2]	**-49.1**	**24.5**	**1,466.7**	**1,498.5**	**-31.8**	**-9.2**	**-31.7**

[1] The carry figures show the contribution of each currency portfolio to the overall carry. Numbers for 2006–07 do not include the IMF reserve position and associated liabilities.

[2] Excludes gold holdings.

Total Return on Market-Value Basis

Table 7 provides an estimate of the total return on a market-value basis for the EFA as a whole and its key portfolios compared to the corresponding liabilities.[5] The net total return was +31 basis points, or US$105 million, in the fiscal year ending March 31, 2007 compared to +17 basis points, or US$44 million, in the 15 months ending March 31, 2006. This reflects net returns in US dollar terms of +21 basis points for the US-dollar portfolio, +43 basis points for the euro portfolio and +18 basis points for the yen portfolio. These numbers include interest flows as well as all gains or losses earned over the period, regardless of whether they were realized or not.

[5] Excluding gold, SDR holdings and the IMF reserve position as those assets are not actively managed on an integrated asset-liability basis.

Table 7

Total Return for the EFA Compared to Liability Benchmarks

	January 1, 2005 to March 31, 2006	April 1, 2006 to March 31, 2007			
	Total EFA	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio					
Return in original currency	**n/a**	5.69%	2.30%	0.93%	**n/a**
Return in US$ (A)	**-3.42%**	5.69%	12.80%	0.82%	**8.62%**
Liability benchmarks					
Return in original currency	**n/a**	5.47%	1.92%	0.74%	**n/a**
Return in US$ (B)	**-3.60%**	5.47%	12.36%	0.64%	**8.31%**
Return vs. liability benchmark in basis points					
(A – B) in US$	**17**	21	43	18	**31**

Table 8 compares the total return for the EFA to a set of Merrill Lynch government securities indices. This provides some insight into how it compares to a portfolio invested solely in US Treasury and German government securities. While the indices have been combined and weighted to reflect the currency composition and duration of the EFA, they only provide a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the fiscal year ending March 31, 2007, the EFA's total return exceeded that of the external indices by 15 basis points, compared to an underperformance of 2 basis points in the 15 months ending March 31, 2006. The EFA's excess return this fiscal year was largely due to the strong performance of its non-US-Treasury US-dollar investments.

Table 8

Total Return for the EFA Compared to External Indices[1]

	April 1, 2006 to March 31, 2007		
	US$ portfolio	Euro portfolio	Yen portfolio
EFA asset portfolio			
Return in original currency (A)	5.69%	2.30%	0.93%
Return in US$	5.69%	12.80%	0.82%
External indices			
Return in original currency (B)	5.38%	2.30%	n/a
Return in US$[2]	5.38%	12.80%	n/a
Return vs. external indices in basis points (A – B) in original currency	31	0	n/a

[1] Composite indices are constructed as weighted averages of Merrill Lynch US Treasury and German government indices.

[2] Return versus external indices is expressed in original currency except for the total EFA, where both assets and index returns are converted to US dollars.

Performance Attribution

Table 9 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the fiscal year ending March 31, 2007. They indicate the coupon effects and credit spread changes were the main sources of original currency return for both portfolios. Although total returns on both portfolios were significantly affected by interest rate movements over the period, similar effects were observed in the corresponding liabilities. This demonstrates a central requirement of the asset-liability management framework of the EFA was achieved over the reporting period. The US-dollar portfolio also earned about 1 basis point from securities-lending activities over the period, since some of its securities were in high demand in the market.

Table 9

Performance Attribution for the US Dollar and Euro Portfolios Compared to Liability Benchmarks

	April 1, 2006 to March 31, 2007			
	US$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	5.22	5.12	3.81	3.71
Yield curve change	0.30	0.39	-1.68	-1.69
Credit spread change	0.19	-0.07	0.24	-0.15
Securities-lending revenue	0.01			
Residual returns	-0.04	0.04	-0.05	0.04
Return in original currency	5.69	5.48	2.31	1.92

Risk Measures[6]

The risk management framework covers market, credit, liquidity, legal and operational risks related to the financing and investment of the foreign reserves. Risk measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada. The Minister of Finance receives an annual report on treasury risk management that is prepared in collaboration with the Bank of Canada's Financial Risk Office.

Market Risk

Several industry-standard measures of market risk exposure were employed: scenario analysis, stress testing and Value-at-Risk (VaR) (Table 10).

Stress tests were regularly carried out to gauge the sensitivity of the EFA portfolio to large changes in exchange rates and interest rates, including the portfolio impact of a 1 per cent depreciation of the euro and yen vis-à-vis the US dollar and a 1 per cent increase in interest rates across the yield curve. The results showed that, on a net basis during the reporting period, the EFA assets and the associated liabilities had very minimal exposure to currency depreciations and upward shifts in the yield curve, comparable to their positions as at March 31, 2006.

[6] These risk measures apply to the EFA only, excluding the SDRs and gold holdings.

In addition, some hypothetical scenario stress tests that mimic the market conditions during four previous extraordinary market events were regularly conducted: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The four stress tests showed that the EFA would generally perform well during such periods of market turbulence. The results were similar to those reported for March 31, 2006, and show that on a net basis, the EFA was continuously well positioned to benefit from flight-to-quality effects.

Table 10

Market Risk Measures

	March 31, 2007		March 31, 2006	
Risk measure	**EFA**	**EFA assets less liabilities**	**EFA**	**EFA assets less liabilities**
	(millions of US dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-180	-3	-138	-2
1% upward parallel shift in yield curve	-963	-27	-801	2
Scenario tests				
1994 Fed tightening	-2,670	75	-2,198	85
1997 Asian financial crisis	-982	30	-713	54
1998 Russian default/LTCM collapse	-1,381	6	-989	45
2001 terrorist attacks	1,100	10	889	14
99% 10-day VaR	643	15	609	14

Market VaR is a statistical measure that estimates the expected loss in portfolio value within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is regularly reported for the entire EFA portfolio and on the net position between assets and liabilities. As of March 31, 2007, the EFA had a 99 per cent 10-day VaR of US$15 million, little changed from at March 31, 2006, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than US$15 million, on a net basis, over a 10 trading-day period.

Credit Risk

The Credit VaR model and some selected credit risk stress tests were used to measure the EFA's exposure to credit risk during the reporting period (Table 11).

Table 11
Credit Risk Measures

Risk measure	March 31, 2007
	(millions of US dollars)
Credit VaR and expected shortfall	
99.9% 365-day Credit VaR	493
Expected shortfall	1,402
Stress test	
Potential loss if counterparties with negative outlook are downgraded one notch	0.1

The Credit VaR model provides an estimate of the maximum expected loss in portfolio value within a year as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. As of March 31, 2007, the EFA had a 99.9 per cent 1-year Credit VaR of US$493 million, which implied that 99.9 per cent of the time, the value of the portfolio was not expected to decline by more than US$493 million over a 1-year period due to credit events. An associated measure, expected shortfall, computes the expected average loss in portfolio value during the same period due to an extreme, unexpected credit event, whose possibility of happening (less than 0.1 per cent) was not captured by the Credit VaR statistic. The expected shortfall measure for the EFA was US$1.4 billion as of March 31, 2007.

Credit risk stress tests were also carried out to evaluate potential losses to the EFA assets and the associated liabilities arising from extraordinary credit events in the market. These tests subjected the EFA to hypothetical scenarios, such as all counterparties with a negative outlook being downgraded by one notch. They showed that the EFA would perform well in this type of scenario.

Annex 1: Statement of Investment Policy

1. Purpose of Policy

This document sets out the policy, approved by the Minister of Finance under the *Currency Act*, governing the acquisition, management and divestiture of assets for the Exchange Fund Account (EFA).

2. Purpose of EFA

The Exchange Fund Account is the principal repository of the Government of Canada's official international reserves. Its purpose is to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market and to provide foreign currency liquidity for the Government of Canada.

3. Governance

Part II of the *Currency Act* governs the management of the EFA. As amended in 2005, the act requires the Minister of Finance to establish an investment policy for EFA assets. Responsibility for the implementation of approved policy and strategy is delegated to officials of the Department of Finance and the Bank of Canada. Details of the governance framework are provided in the *Treasury Management Governance Framework.*

4. No Inconsistent Business or Activity

This policy prohibits any business or activity that is inconsistent with the investment objectives set forth below or in a manner that is contrary to the *Currency Act.*

5. Investment Objective

There are three investment objectives:

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis[7] (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

[7] Liabilities, which fund EFA assets, are managed outside the EFA.

6. Investment Policy

6.1 Eligible Asset Classes

The EFA may hold the following classes of assets: 1) fixed income securities (including bonds, notes, bills and short-term discount notes/commercial paper) issued by sovereigns (including directly guaranteed agencies), central banks, government-supported entities and supranational institutions; 2) deposits with commercial banks, central banks and the Bank for International Settlements; 3) repurchase agreements; 4) commercial paper and certificates of deposit issued by private sector entities; 5) gold; and 6) International Monetary Fund (IMF) special drawing rights. Subject to section 6.9, bonds with embedded options (such as callable bonds) and holdings of securities issued by and deposits with Canadian-domiciled entities (or entities that derive a majority of their revenues from their Canadian operations) are not permitted. All other classes of assets not listed in this policy are prohibited.

6.2 Eligible Investment Ratings

Eligibility for investment in the EFA is based on external credit ratings. To be eligible for investment, an entity must have a credit rating in the top seven categories from at least two of the four main rating agencies: Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. When there are two or more ratings for an entity, the rating of the second highest rating agency will be used to assess eligibility.[8]

The only allowable unrated investments are the following: a) securities issued by and deposits with central banks and the Bank for International Settlements and b) investments in special drawing rights created by the IMF.

Ratings agency	Minimum rating
Moody's Investors Service	A3
Standard & Poor's	A-
Fitch Ratings	A
Dominion Bond Rating Service	A (low)

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

6.3 Credit Exposure Limits

Exposure limits are based on credit quality for classes of assets, aggregate and individual counterparties.

6.3.1 Fixed Income Securities

Exposure to fixed income securities issued by sovereigns (including directly guaranteed agencies), government-supported entities and supranational institutions are determined by credit rating and by currency of issuance, as shown in the table below.

[8] However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).

Issuer	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies) and AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
A- to A+ sovereigns (including directly guaranteed agencies)	2	See below[1]
Government-supported entities (senior unsecured obligations)	15	3
Supranationals (excluding Bank for International Settlements)	25	10

Note: All amounts are expressed in par values.

[1] *Individual exposure limits for single-A sovereigns (including directly guaranteed agencies) are as follows:*

Credit rating	Total exposure	Of which home currency	Of which foreign currency
		(millions of US dollars)	
A+	500	500	50
A	250	250	25
A-	100	100	10

Note: All amounts are expressed in par values.

6.3.2 Deposits and Other Short-Term Securities

Aggregate and individual exposure limits exist for deposits and other eligible securities. A maximum of 10 per cent of the reserves target level (based on par values) may be invested in deposits and securities of the Bank for International Settlements. Aggregate limits of US$1.5 billion and US$1 billion (based on par values), respectively, are imposed on commercial bank deposits and commercial paper/certificates of deposit issued by private sector entities.

Individual exposure limits to private sector entities in the form of forwards, deposits, commercial paper and certificates of deposit, together with swaps used for funding purposes, are determined by credit rating, as shown in the following table. These limits are cumulative across all lines of business and represent the mark-to-market value for swaps and forwards and the par-value exposure for deposits, commercial paper and certificates of deposit. Total exposure to private sector entities may not exceed 25 per cent of the reserves target level, with a maximum of 2 per cent of the reserves target level for private sector entities rated A+ to A-.

Actual exposure limits by credit rating of private sector counterparties/issuers[1]

	AAA	AA+	AA	AA-	A+	A	A-
				(millions of US dollars)			
Individual exposure	300	200	150	100	50	25	10

[1] Represents par value for deposits, commercial paper and certificates of deposit and mark-to-market value for swaps and forwards.

6.4 Structure of EFA Holdings

Investments will be held in either a Liquidity Tier or an Investment Tier. Only highly liquid US-dollar-denominated securities are eligible for investment in the Liquidity Tier: 1) sovereign (including directly guaranteed agencies) and supranational securities; 2) US government-supported entity securities; 3) US and European government-supported entity discount notes and commercial paper; 4) callable Bank for International Settlement deposits and medium-term investments; 5) overnight commercial bank deposits; 6) commercial paper and certificates of deposit issued by private sector entities; and 7) overnight repurchase agreements.

6.5 Eligible Currencies

The Exchange Fund Account may hold US dollars, euros, Japanese yen and IMF special drawing rights. The minimum floor for US-dollar-denominated securities is US$12 billion on a market-value basis.

6.6 Terms of Investments

The maximum term to maturity of EFA assets is based on type of instrument, credit rating and currency of issuance, as shown in the following table.

Instrument	Maximum term to maturity
Marketable securities from issuers rated AA- or better	10.5 years
Investments from issuers rated A+ or lower	5 years if the investment is denominated in domestic currency
	1 year if the investment is denominated in foreign currency
Commercial paper and certificates of deposit	1 year
Commercial bank deposits and repurchase agreements	3 months

6.7 Permitted Activities

EFA officials may acquire or borrow assets to be held in the EFA and sell or lend those assets. Short sales are prohibited.

6.8 Use of Derivatives

EFA officials may use derivatives to mitigate risk and reduce costs. Derivatives shall not be used to establish speculative or leveraged positions.

6.9 Securities Lending and Repurchase Agreements

EFA officials may lend or borrow securities held in the EFA through a securities-lending program or repurchase agreements to enhance portfolio returns, provided it does not compromise liquidity or engender material exposure to loss. Officials are responsible for appointing and supervising agents, determining eligible collateral and setting collateral margins. Eligible collateral may include, but is not limited to, bonds with embedded options. Officials have the authority to either manage themselves or delegate to an agent the authority to select borrowers, negotiate terms to maturity and rates, and invest cash or securities collateral.

6.10 Exceptions

In exceptional circumstances such as a ratings downgrade or an event of default, the EFA may hold assets (acquired either through direct investment or by taking possession of collateral following an event of default) that do not otherwise meet the criteria for eligible asset classes and/or breach the credit exposure limits, provided that timely efforts are made to divest the EFA of those assets or otherwise bring any such exceptional holdings into compliance.

7. Performance Assessment and Risk Management

Officials are responsible for measuring, monitoring and reporting on the performance and risk exposures of the EFA and tracking these positions against appropriate indices. Performance and risk exposures will be reported on a timely and regular basis to a risk committee that has the capacity to provide an independent view of operations, to a management committee, and to senior management from the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament. Measures should be consistent with leading practices in the private sector and provide information on the returns on EFA assets, the cost of associated liabilities and financial risks. Detailed information on the Government's risk management policies is provided in the *Government of Canada Treasury Risk Management Framework.*

8. Review

The *Statement of Investment Policy* will be reviewed annually and updated as required. Investment programs and practices should be subject to periodic external review to ensure that they contribute effectively to the achievement of EFA objectives.

Annex 2: Official Intervention

Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy. The goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Since September 1998 the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[9]

Table 12

Official Intervention

	2002	2003	2004	January 1, 2005 to March 31, 2006	March 31, 2006 to March 31, 2007
			(millions of US dollars)		
Purchases	–	–	–	–	–
Sales	–	–	–	–	–
Net	–	–	–	–	–

[9] Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

Annex 3: Canada's Official International Reserves

Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change	Reserves management operations[4]	Gains and losses on gold sales	Return on investments[5]	Foreign currency debt charges	Revaluation effects	Net government operations[6]	Official intervention	Other transactions[7]
							(market value in millions of US dollars)								
2006															
March	28,420	5,596	63	917	1,038	36,034	-215	1,710	0	523	-1,326	-1,122	0	0	0
2006–07															
April	29,606	4,051	70	931	1,058	35,716	-318	-872	0	29	-85	610	0	0	0
May	29,601	3,960	71	949	1,103	35,684	-32	-354	0	125	-70	267	0	0	0
June	30,230	3,584	67	939	1,092	35,912	228	631	0	22	-375	-49	0	0	-1
July	30,514	3,770	69	942	1,096	36,391	479	372	0	250	-135	-8	0	0	0
August	29,989	3,748	68	949	1,099	35,853	-538	-804	0	270	-47	42	0	0	0
September	29,161	4,760	65	941	1,090	36,017	164	272	0	151	-72	-187	0	0	0
October	29,712	3,976	66	944	945	35,643	-374	-452	0	107	-150	121	0	0	0
November	30,284	4,291	70	965	867	36,477	834	42	0	193	-81	680	0	0	0
December	30,197	3,001	69	963	833	35,063	-1,414	-974	0	-125	-229	-87	0	0	1
January	30,425	3,633	71	954	825	35,908	845	1,047	0	32	-13	-220	0	0	-1
February	31,569	2,983	72	966	720	36,310	402	-159	0	288	-12	285	0	0	0
March	33,657	3,882	72	976	722	39,309	2,999	2,882	0	50	-104	171	0	0	0
Total[8]	n/a	n/a	n/a	n/a	n/a	n/a	3,275	1,631	0	1,392	-1,373	1,625	0	0	-1

[1] Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

[2] Special drawing right (SDR)-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

[3] The reserve position in the IMF represents the amount of foreign exchange that Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

[4] Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

[5] Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

[6] Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

[7] Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

[8] Numbers are from the Official International Reserves press release.

Annex 4: List of Agents and Mandataries as Defined by the *Currency Act*

The *Currency Act* stipulates that this report include a list of the following agents and mandataries appointed by the Minister under subsection 17.2(3) of the act to perform services concerning the EFA.

Bank of Canada

The Bank of Canada, as specified under the *Bank of Canada Act*, is the fiscal agent for the Government of Canada. As part of its fiscal agency responsibilities, the Bank manages the Government's foreign exchange reserves.

RBC Dexia Investor Services and State Street Corporation

RBC Dexia Investor Services and State Street Corporation manage the securities-lending program for the EFA. As the Government's agents and mandataries, they carry out securities lending on behalf of the Government. The program involves loaning a security from the Government to a counterparty, who must eventually return the same security, in order to earn additional return on the portfolio.

Annex 5: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through JP Morgan Chase Bank in New York City. Primary distribution occurs through five dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

certificate of deposit: Promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand. Although it is still possible to withdraw the money, this action will often incur a penalty.

commercial paper: Senior level unsecured short-term debt that is a source of cost-effective short-term financing available to the largest and most creditworthy issuers relative to bank loans.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

euro medium-term note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley. The maturities of EMTNs are not fixed, and can range from short- to long-term. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

repo; repurchase agreement: Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. These transactions are similar to secured loans where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized by other high quality securities. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

special drawing right (SDR): An international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of international currencies.



Exchange Fund Account

Financial Statements

31 March 2007

Exchange Fund Account

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Bank of Canada administers the Account, as fiscal agent of the Government of Canada.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which are consistent with those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and for related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
4 May 2007



Auditor General of Canada
Vérificatrice générale du Canada

Auditor's Report

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at 31 March 2007 and the statements of revenue and cash flows for the year then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at 31 March 2007 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
4 May 2007

Exchange Fund Account

Balance Sheet as at 31 March

	2007	2006
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 3)	1,925	4,239
Deposits held under repurchase agreements (note 4)	2,540	2,278
Marketable securities (note 5)	38,463	32,855
	42,928	39,372
Other assets		
Special drawing rights	1,119	1,065
Gold	7	6
Accrued interest (note 6)	619	493
	1,745	1,564
	44,673	**40,936**
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 7)	42,908	39,202
Net revenue for the year	1,765	1,734
	44,673	**40,936**

Approved:

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Revenue
For the year ended 31 March

	2007 (12 months)	2006 (15 months)
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,368	1,840
Cash and short term deposits	109	104
Deposits held under repurchase agreements	105	46
Special drawing rights	42	37
	1,624	2,027
Other revenue		
Net gain (loss) on foreign exchange	141	(293)
Net revenue for the year	1,765	1,734

(The accompanying notes are an integral part of these financial statements)

Exchange Fund Account

Statement of Cash flows
For the year ended 31 March

	2007 (12 months)	2006 (15 months)
	(millions of Canadian dollars)	
Cash flows from operating activities		
Interest received		
Marketable securities	995	1,476
Securities lending activities	3	8
Short term deposits	100	85
Deposits held under repurchase agreements	102	37
Other	15	10
Purchase of marketable securities	(60,028)	(63,093)
Proceeds from the sale or maturity of marketable securities	55,937	59,688
Increase in foreign currencies	459	3,407
Decrease in foreign currencies	(1,563)	(2,777)
Cash used in operating activities	**(3,980)**	**(1,159)**
Cash flows from financing activities		
Increase in advances	19,418	31,255
Repayment of advances	(17,400)	(26,131)
Cash provided by financing activities	**2,018**	**5,124**
Effects of exchange rate changes on cash and cash equivalents	(90)	(116)
Increase (decrease) in cash and cash equivalents	**(2,052)**	**3,849**
Cash and cash equivalents		
Balance, beginning of year	6,517	2,668
Balance, end of year	**4,465**	**6,517**
Represented by		
Cash and short term deposits	1,925	4,239
Deposits held under repurchase agreements	2,540	2,278
	4,465	**6,517**

(The accompanying notes are an integral part of these financial statements)

Exchange Fund Account

Notes to the financial statements
For the year ended 31 March 2007

(Amounts in the notes to the financial statements are in millions of Canadian dollars, unless otherwise stated.)

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account. The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 98 per cent (97 per cent as at 31 March 2006) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the Act.

The objective of the Exchange Fund Account is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the Account are managed to provide foreign-currency liquidity to the government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

In accordance with the *Currency Act*, the net revenue for the year is paid to or charged to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the fiscal year, and the Minister of Finance reports to Parliament on the operations of the Account within the first 60 days on which Parliament is sitting after the end of the fiscal year.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in a manner consistent with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

a) Change in Year-end

Amendments to the *Currency Act* came into effect on 30 December 2005 and included changing the reporting year of the Account, which had been the calendar year, to a fiscal year ending 31 March. The amendments included a provision for a 15-month transitional period ending 31 March 2006.

b) Reporting entity

The reporting entity of the Account is limited to those transactions permitted by a policy established by the Minister of Finance. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Minister of Finance.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada. These costs are not recognized in the financial statements.

c) Basis of Presentation

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances.

d) Use of estimates

The preparation of the financial statements of the Account requires management to make estimates and assumptions, based on information available as of the date of the financial statements. The most significant use of estimates is in the presentation of assets at fair value. Actual results could differ significantly from those estimates.

e) Translation of foreign currencies and Special Drawing Rights

Assets and advances denominated in foreign currencies and special drawing rights (SDRs) are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates, which were as follows:

	2007	2006
US dollars	1.1546	1.1680
Euros	1.5424	1.4153
Japanese yen	0.009799	0.009923
SDR's	1.74367	1.68291

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the fiscal year, are recorded as net foreign exchange gains or losses and are included in the category *Other revenue* in the *Statement of Revenue.*

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

f) Revenue

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Interest is accrued on short-term deposits, deposits held under repurchase agreements, marketable securities, and special drawing rights. Accrued interest is recorded in the category *Other assets* on the *Balance sheet.*

g) Assets

Short-term deposits

Short-term deposits are money market transactions where the Account invests funds with designated counterparties. Short-term deposits are recorded at cost and are generally held to maturity.

Deposits held under repurchase agreements

Deposits held under repurchase agreements are money market transactions where the Account invests funds on a secured basis with designated counterparties at prevailing market rates based on tri-party reverse repurchase agreements. The collateral on these transactions is held by a tri-party custodian. Deposits held under repurchase agreements are recorded at the amount originally invested.

Marketable securities

Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums. Purchases and sales of securities are recorded at the settlement dates.

Write-downs to reflect other than temporary impairment in the fair value of securities are included in *Revenue from investments* in the *Statement of Revenue.*

Special Drawing Rights

The special drawing right (SDR) serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. SDRs are recorded at fiscal year-end market value.

Gold

Gold is carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada.* The Account sold its remaining gold bullion in 2003 and continues to hold gold coins. Net gains on gold sales are recorded at settlement dates.

h) Securities Lending Program

The Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. The securities loaned continue to be accounted for as investment assets. Revenue from the securities-lending program is included in *Revenue from investments* in the *Statement of Revenue.*

3. Cash and Short-term Deposits

	2007 Carrying Value	2006 Carrying Value
US dollars	1,548	4,065
Euros	295	91
Japanese yen	82	83
	1,925	4,239

4. Deposits Held Under Repurchase Agreements

	2007 Carrying Value	2006 Carrying Value
US dollars	2,540	2,278

At 31 March 2007, the term to maturity of deposits held under repurchase agreements was less than 3 months.

5. Marketable Securities

Term to maturity

	2007									2006
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Carrying value
US dollar										
Commercial Banks	922	5.24%	–	–	–	–	–	–	922	–
Sovereign	4,706	5.53%	–	–	246	4.47%	552	4.68%	5,504	6,252
Supra National	1,886	4.84%	23	4.80%	1,146	4.74%	1,522	4.88%	4,577	3,977
Agencies and other	3,210	4.87%	363	5.16%	2,165	4.93%	1,626	4.90%	7,364	7,113
Carrying value	10,724		386		3,557		3,700		18,367	17,342
Euro										
Sovereign	409	3.58%	120	3.59%	7,178	3.77%	3,369	3.83%	11,076	10,261
Supra National	–	–	115	3.70%	577	4.17%	840	3.75%	1,532	1,000
Agencies and other	230	4.77%	270	2.64%	4,161	3.78%	2,337	3.89%	6,998	3,756
Carrying value	639		505		11,916		6,546		19,606	15,017
Japanese yen										
Sovereign	–	–	–	–	490	1.91%	–	–	490	496
Carrying value	–		–		490		–		490	496
Total securities										
Carrying value	11,363		891		15,963		10,246		38,463	32,855

The yield in the above table represents the weighted average yield to maturity based on the carrying value at the end of the fiscal year for the respective securities.

The unamortized premium/discount on marketable securities amounts to $4 million ($193 million at 31 March 2006).

At 31 March 2007, a portion of the Account's holdings of US government securities, consisting of US$2,355 million (par value) in Treasury Bills (US$1,815 million (par value) at 31 March 2006) and US$359 million (par value) in Treasury Notes (US$1,130 million (par value) at 31 March 2006), is being used in securities-lending operations with financial institutions.

6. Accrued Interest

	2007	2006
Accrued interest		
Cash and short-term deposits	7	12
Deposits held under repurchase agreements	11	9
Marketable securities		
US Dollar	114	107
Euro	479	359
SDR's	8	6
	619	493

The fair value of the accrued interest is deemed equal to their carrying value given their short term to maturity.

7. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to $60 billion by order of the Minister of Finance dated 30 December 2005. At fiscal year-end, advances from (deposits with) the CRF consisted of:

	2007	2006
US dollars	23,078	24,698
Canadian dollars	960	349
Euros	19,366	14,606
Japanese yen	568	576
SDR's	(1,064)	(1,027)
	42,908	39,202

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

8. Financial Instruments

a) Risk management

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the Account's asset portfolio is prudently diversified with respect to credit risk, the Statement of Investment Policy prescribed by the Minister of Finance specifies limits on holdings by class of issuer (sovereign, agency, supranational, corporation or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to the Statement of Investment Policy, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues must have a credit rating in the top seven categories from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service). The Account may also make deposits and execute other transactions, up to prescribed limits, with commercial financial institutions that meet the same rating criteria.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the Government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to increase its return on investments.

b) Interest rate and foreign currency risk

Interest rate and foreign currency risks are managed, with due consideration of the risk to the Government of Canada, by adopting a strategy of matching the duration structure and the currency of the Account's assets with the foreign currency borrowings of the Government of Canada that fund the Account's assets.

c) Fair value of financial instruments

	2007		2006	
	Carrying Value and Accrued Interest	Fair value	Carrying Value and Accrued Interest	Fair value
Investments				
Cash and short-term deposits	1,932	1,932	4,251	4,251
Deposits held under repurchase agreements	2,551	2,551	2,287	2,287
Marketable securities				
US dollar	18,481	18,466	17,449	17,235
Euro	20,085	19,893	15,376	15,448
Japanese Yen	490	501	496	511
	43,539	43,343	39,859	39,732
SDRs	1,127	1,127	1,071	1,071
Gold	7	83	6	74
	44,673	44,553	40,936	40,877

The estimated fair value of cash, short-term deposits, deposits held under repurchase agreements and SDRs is deemed equal to their carrying value given their short term to maturity.

Estimated fair values of marketable securities are based on quoted market prices. Prevailing market conditions at 31 March 2007 reduced fair values on US dollar and Euro marketable securities below carrying values. As it is uncertain that these conditions reflect other than temporary impairment in the fair value, these securities have not been written-down to fair value.

The estimated fair value of gold is based on London fixing of $764.06 at 31 March 2007 ($679.78 at 31 March 2006) per fine ounce.

9. Commitments

a) Currency swaps

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility during the year ended 31 March 2007 or during the 15 month period ended 31 March 2006, and there were no commitments outstanding as at 31 March 2007.

b) Foreign currency contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 March 2007, the Account was under contract to sell $18 million ($25 million at 31 March 2006) of foreign currency. Unrealized gains (losses) on foreign currency contracts are calculated using the 31 March 2007 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 March 2006). Outstanding foreign currency contracts were settled by 2 April 2007.

c) Investment contracts

In the normal course of operations, the Account enters into investment contracts. The following table presents the fair value of investment contracts with contractual amounts outstanding at 31 March 2007. Outstanding investment contracts were settled by 12 April 2007.

	2007		2006	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US Dollars				
Purchases	(115)	(115)	(663)	(663)
Sales	116	116	82	82
Euro				
Purchases	(35)	(35)	(94)	(94)
Sales	36	36	93	93

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.

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